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**Task Order No. 003 : National Stock Exchange
(NSE) of India Ltd.**

**Review of rules and regulations of National
Stock Exchange of India Ltd. and its status
as a self-regulatory organization**

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30 October, 1995

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Dear Dr. Patil,

**Re: Review of rules and regulations of National Stock Exchange of India Ltd.
and its status as a self-regulatory organization**

As a part of our contract with US/AID, we have completed our activity under Task Order No. 3. The purpose of this activity was to provide you with our comments, recommendations and insights as to the adequacy of the framework of rules and regulations of your Exchange and its status as a self-regulatory organization.

We are pleased to observe that the National Stock Exchange is under able and dedicated leadership committed to operating a transparent, well regulated, ethical marketplace in the public interest and to being an effective self-regulatory organization. It has in place an extensive system of byelaws, rules and regulations designed to achieve that end and which comport with those objectives.

Improvements can be made, however. Suggested improvements are embodied in the recommendations which follow.

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Summary Of Recommendations

It is recommended that:

General

1. NSE encourage SEBI to clearly delineate what is expected of self-regulatory organizations and to define the relationship between the self-regulator and SEBI. If accomplished, NSE will be able to pursue its goals with greater confidence and reduce potential future differences with SEBI.

Governance of the exchange

2. The makeup and/or function of the Executive Committee be modified in at least the following four respects:

- a. a specific provision be placed in the Byelaws to enable listed companies to be represented thereon. They are one of the three constituencies of a securities exchange: issuers, investors and members. Without them there would be no product to trade.
- b. sufficient flexibility be built into the organizational documents to provide for regional representation on the Executive Committee. This will make management more fair and equitable as the Exchange grows and becomes truly nationwide. Local considerations should be factored into policy determinations that may affect one or more of the regions.
- c. a system of regional committees be developed as the Exchange expands nationwide to address, at the initial level, disciplinary cases. Under this system the Executive Committee's Disciplinary Subcommittee would become an appellate body for disciplinary cases. The regional committees could also be utilized to make policy recommendations to the Executive Committee.
- d. in time, delete the provisions enabling the Central Government and SEBI to each nominate a person to the Executive Committee. Government involvement in the operation of a self-regulatory organization is antithetical to

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the concept and could stifle initiative and creativity. Short term involvement may be beneficial to NSE, however.

The marketplace

3. For greater transparency in the market, odd lot trades and trades in excess of Rs. 10 million be required to be reported within 90 seconds, or at the most within 5 minutes. These trades, which are permitted to be executed off the system, are not required to be reported for 24 hours.
4. When the Exchange's clearing subsidiary is operational, a depository is in place and the legal situation as to stock transfers has been clarified, move toward a rolling settlement with the ultimate objective of achieving the Group of 30's recommendation of settlement on T plus 3.
5. If the market maker system permitted by the Bye laws (though at this point not utilized) is retained, require market makers to make a continuous market for a specified period of time once they opt to commence market making. Such would add liquidity to the market in the selected securities and provide continuity which may not otherwise be present.
6. The practice of publishing as the end of day closing price the average price for the last half hour of the Exchange's operation be reviewed. This review should weigh the necessity of the public's entitlement to the correct closing price against the reason for the practice, to wit, circumvention of a practice of inputting fictitious or contrived trades.

The membership

7. The current "net worth" requirements be redesignated as "net capital" requirements, establish a singular method of computing net capital and incorporate the requirements into the regulations of the Exchange.
8. The membership of the Membership Application Committee be expanded to include representatives of the membership. Long term, make the function of accepting applications for membership a staff function administering objective standards and forwarding to the Committee questionable situations or rejected applications.

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9. Employees of members, especially authorized persons actively engaged in the securities business on behalf of members, be required to take a qualification examination testing their knowledge of the capital and debt markets, the laws and regulations applicable thereto and the rules and regulations of the stock exchange before they are permitted to engage in such activities. During the interim, all persons dealing with the public be required to take such a qualification examination.

The staff

10. All regulatory, surveillance and compliance activities be gathered together into a discrete segment of the Exchange and that a full time Senior Officer be appointed to manage and build this function. This is an extremely important part of the Exchange's responsibility to act in the public interest and for the protection of investors.

11. Staff inspections of members operations be materially increased in number as rapidly as possible with an ultimate goal of inspection of all members at least once per year; that a shorter term objective be at least once every other year.

12. Member inspections eventually be conducted entirely by employees of the Exchange without the assistance of outside auditors. This will enable the Exchange to have greater control over the inspection process and eliminate the possibility of conflicts of interest between the outside auditors and the member being inspected. A complaint was made to the Consultant during his review of the process that one of the outside inspectors was employed by a competitor of the firm being examined.

13. Goals and a plan of action to accomplish annual inspection cycles by entirely Exchange personnel be promptly adopted.

14. As the Exchange expands nationwide, the regional committees created for disciplinary purposes be supported by a Regional Office which would be staffed by a team of inspectors who would conduct the required inspections of members' offices in the region. The staff, headed by a Manager, would also coordinate the activities of the Regional Committee.

15. A consultant experienced in the design and development of a market surveillance system be retained to assist with such in connection with the Exchange's planned new market surveillance system.

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16. Appropriate NSE personnel receive detailed training in the proper techniques of reviewing material generated by the system and pursuing follow-up investigations, and that such training take place in the United States, preferably at Nasdaq or the New York Stock Exchange.

17. The head of the Legal Department be upgraded to a senior management position and the department's functions and responsibilities be made more clear in the manner delineated in the body of this report. Among other things, the Department should be totally immersed in the rule making process to ensure that rules being adopted, or amendments to existing rules, are consistent with law and corporate policy. The Legal Department serves a very important function and has significant responsibility for the proper operation of the Exchange and the corporation of which it is part. Its responsibilities should be emphasized to the Exchange staff which should feel free to consult with the Department on all matters and should be required to do so on others.

Regulatory structure

18. The structure and organization of the rules and regulations be revised, and certain of them be amended and others added.

19. The Capital Market Segment Regulations and the Debt Market Regulations be consolidated as Marketplace Regulations with the provisions which apply to both market segments stated only once and regulations applying to one or the other of the market segments be specifically stated as such under separate headings.

20. As the NSE Manual recommended below is being developed, the Byelaws, Rules, Regulations, Circulars and any other documents which purport to be regulations be reviewed and rewritten as necessary to conform to the above recommendation.

21. Every effort be made to put substantive requirements in regulations and eliminate general authorizing language such as "shall be subject to such terms and conditions as the exchange may from time to time decide" to eliminate the potential perception that the Exchange could change the provision on a whim or adopt different standards for different people.

22. An Arbitration Code applicable to all market segments which the Exchange may sponsor be adopted and called such and be included as part of the Procedures segment of NSE Manual.

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23. The Arbitration Code provide for public participation on an arbitration panel involving a customer, that three person arbitration panels be provided for in all but minor cases, that representation by counsel be permitted without the necessity of getting approval of the panel, that the Code or another rule of the Exchange provide that the failure by a member to promptly pay an arbitration award shall result in suspension or termination of membership, that the universe of persons from whom parties to an arbitration select an arbitrator be expanded considerably and the Arbitration Code be drafted consistent with the Indian Arbitration Law.

24. All matters which impose or change a standard of conduct, have the effect of restraining or requiring action or which otherwise modify the rights, responsibilities and obligations of members, their employees, issuers and/or investors be required to be affirmatively adopted at least by the Executive Committee.

25. All of the Byelaws, Rules and Regulations (by whatever name known) be incorporated into one "NSE Member Manual" which would be produced in hard cover, loose leaf form so it can be modified as new regulations are adopted. The Manual should also be produced in a lesser expensive paperback form of which members could purchase multiple copies at a reasonable cost for distribution to their personnel. This publication would be revised at least once per year.

Rules and regulations : recommendations

26. The Capital Market Segment Regulations and the Debt Market Segment Regulations be completely rewritten to eliminate the situation which currently exists whereby many provisions of each seem applicable to the other but are not included in the other regulations, where some provisions are treated in more detail in one or the other of the segments when it appears the provisions could apply equally to both, and where there are differences in language in the two sets of regulations addressing the same subject. See recommendation 18 above that the regulations of both segments be consolidated and provisions applicable to only one or the other be separated under separate headings.

27. There are approximately 35 recommendations made for language changes or other modifications in various of the existing regulations of both of market segments. They will not be repeated here but can be found on pages 29 through 35.

28. The following new regulations discussed on pages 35 through 38 be adopted:

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- a. Net Capital Rule
- b. Order Ticket Rule
- c. Rule concerning Influencing or Rewarding Employees of Others
- d. Rule concerning Charges for Services Performed and Fair Prices and Commissions.
- e. Rule concerning Prohibition on Publication of False Quotations
- f. Rule concerning Prohibition on Extreme Quotations
- g. Rule concerning Prohibition Against Payments to Influence Market Prices
- h. Rule concerning Prohibition on Publication of Fictitious Transactions and Wash Sales
- i. Rule concerning Proxies
- j. Rule concerning Separation of Personnel
- k. Rule requiring Sending of Customer Account Statements
- l. Rule requiring Compliance Departments/Officers/Supervisory Procedures
- m. Rule requiring Reports of Non-Compliance
- n. Rule concerning Fidelity Insurance

Compliance and disciplinary mechanism

29. Customer complaint, terminations for cause and examinations for cause programs be added to those already started by the Exchange to make more complete its compliance mechanism.

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30. The Exchange's disciplinary mechanism be improved by, among other things, granting the right to representation by counsel and the creation of an appeal mechanism.

Staff training

31. Staff training particularly in specialized areas such as insider trading and manipulation investigations, the structure and operation of a periodic examination program and the operation of a market surveillance system be emphasized This training should probably be in the United States from persons experienced in these kinds of investigations.

Code of conduct

32. A Code of Conduct be developed detailing what is expected of employees in a variety of areas, such as among others, conflicts of interest, confidentiality of information, business dealings with others especially those in the industry, securities transactions, outside or private employment and the acceptance of gifts or gratuities.

Conclusion

33. Efforts be immediately undertaken to develop a plan to redesign the governance and corporate structure of NSE in preparation for the time when it becomes a truly national organization, to perfect its compliance, surveillance, disciplinary and arbitration mechanisms, to accent specialized staff training and to make its rules more orderly and comprehensive as recommended in the body of the report.

Finally we would like to express our appreciation to you and your other colleagues at NSE for the time, courtesy and cooperation extended to us during the study.

Please do not hesitate to contact **PW/FIRE Project, Mr. Frank Wilson or me**, at 494-871 8, 494-6630, 492-5250 or by fax at 493-5840, if you require any clarifications on this report.

Yours sincerely,

W. Dennis Grubb

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I. INTRODUCTION

A. Background

This task is part of the Financial Institutions Reform and Expansion (FIRE) Project and arises from a request by management of the National Stock Exchange of India Limited (NSE). Its scope is twofold: (1) to review the Exchange's rules and regulations and to provide advice on how they can be improved, strengthened or expanded; and (2) to evaluate the Exchange from the standpoint of achieving its desired status as an effective self-regulatory organization consistent with international standards. The market surveillance function of the Exchange was specified as being of particular importance.

B. Methodology

In conducting the review, the Consultant, Mr. Frank J. Wilson, was on site in Bombay, India from September 9, 1995, until September 27, 1995, and met with various officials of the NSE, including its Managing Director, Deputy Managing Director, its Vice Presidents, Assistant Vice Presidents and other Exchange personnel; members of the Exchange; the chairman of Technical Advisory Group on Market Surveillance, a committee established by NSE to upgrade its market surveillance system; the Exchange's independent legal advisor; the Chairman and other officials of the Securities Investment Board of India (SEBI) and officers of the Stock Holding Corporation of India Limited. SEBI is the government regulatory agency with oversight responsibilities over the Indian securities industry. A list of persons interviewed is contained in Attachment 1. Also, applicable securities laws and regulations were reviewed as were the Byelaws and all known rules and regulations of the NSE and papers issued by SEBI concerning development, reform and regulation of India's securities markets. The NSE market was observed in operation and its market surveillance function was closely reviewed. At the end of the consultancy, the Consultant conducted a workshop on self-regulation for the Exchange's senior officials and made certain recommendations concerning its regulations and operation.

II. THE NATIONAL STOCK EXCHANGE

A. General

The National Stock Exchange is under able and dedicated leadership committed to operating a transparent, well regulated, ethical marketplace in the public interest and to being an effective self-regulatory organization. It has in place a system of **byelaws**, rules and regulations designed to achieve that end and which comport with those objectives. Its surveillance and compliance programs are in their embryonic stages but they are underway. However, a better focus on these efforts by the Exchange is needed and their importance must be emphasized both internally and externally. The Exchange also has in place a system to enable customers with grievances an opportunity to be heard through an arbitration process. This process is also available for the resolution of member/member disputes. As comprehensive as all of these provisions are, and as compatible as they are with the concept of self-regulation, improvements can be made. Recommendations in this respect are made below.

Self-regulation is advocated as a goal in many developing countries, including India. However, it is a concept that is not clearly understood and in some countries, including India, cultural considerations and the history of market activities may impact its complete introduction in the traditional sense. The NSE structure is counter to the concept of self-regulation in its purest form. That structure, to some degree at least, appears to have been dictated by past market practices in India. Nevertheless, NSE has set about to be a self-regulatory organization and is committed to the process. There is no doubt this can be achieved and that it can claim that status if some modifications are made in its structure as recommended below.

A concept paper on self-regulation is contained at Attachment 2. In the concept paper it is emphasized that unqualified support of the government securities industry regulator is necessary for the concept of self-regulation to work to the maximum extent of its potential. SEBI has on more than one occasion expressed its support for self-regulation and has stated that self-regulation is "the cornerstone of the regulatory framework advocated by SEBI" and that its objective is that "...Stock Exchanges become more effective, responsible self-regulatory organizations with a greater degree of accountability so that they can play an effective role in regulating their members, making their members directly accountable for their actions, help them in maintaining ethical standards and create an environment where there is a willingness towards acceptance of Regulations and regulatory compliance." See document entitled "SEBI and Investor Protection, Development and Regulation of Securities Market" at pages 13 and 25. In that document at page 25, SEBI has also advocated the "strict enforcement of their own rules" by

stock exchanges. These attitudes have been confirmed in meetings with SEBI officials. However, there have been no detailed regulations or other writings by SEBI in which it delineates exactly what is expected of self-regulatory organizations or what the relationship between a self-regulator and SEBI should be in the enforcement of rules and regulations. These matters should be clearly delineated by SEBI. It is strongly recommended that NSE encourage SEBI to do so. Such would enable the Exchange to pursue its objectives with greater confidence and reduce the potential for future differences with SEBI.

Additional comments on self-regulation are made throughout the discussion below.

B. Governance

The National Stock Exchange differs from most exchanges in the world in that it is not owned by its members, the members do not have an equity interest of any kind in the Exchange and they do not have a voice in its operation at the Board level. The Board of Directors of the Exchange is comprised entirely of representatives of its promoters, primarily major financial institutions of India, the Managing Director and Deputy Managing Director of the Exchange, both professional employees thereof, and the Exchange's outside legal counsel. A list of the Exchange's promoters is contained in Attachment 3. The Board is empowered to make rules and regulations for any or all matters relating to the conduct of the business of the exchange.

The activities of the Exchange are governed by an Executive Committee which is required by the Byelaws to be composed of the Managing Director of the Exchange; not more than one person each to be nominated by the Central Government and SEBI; not more than four Trading Members; "public representatives" of an unspecified number who "shall be individual persons of eminence from the fields of finance, accounting, law or other discipline;" and four "other nominees" which may include two ex officio senior officers of the Company, all of whom are nominated by the Board. None of these persons run for election to the Board. They are appointed by the Board. The maximum strength of the Executive Committee is 15 persons. There may be more than one Executive Committee with authority over specific trading segments of the Exchange but only one such committee has been appointed. It has extensive authority over just about all aspects of the Exchange's business. In certain areas, such as promulgation of rules and regulations, Board approval is needed. The Managing Director of the Exchange is its Chief Executive Officer and Chairman of the Executive Committee.

While the membership does not have a voice in the operation of the Exchange at the Board level, it does have a voice at the Executive Committee level because of the requirement that it contain four trading members. It does not, however, have a direct say as to whom they should be. Members also participate on various committees but the members of those committees and the

powers delegated to them are decided by the Board. In addition to the Executive Committee, Committees which have been authorized by the Board are the following: Membership Approval Committee; Wholesale Debt Market Trade Settlements Sub-Committee of the Executive Committee; Committee For Identifying Good and Bad Delivery of Securities; Advisory Committee on Listing of Securities; Disciplinary Action Sub-Committee of the Executive Committee; Committee For Accounting Norms; Working Group on Penalty Points/Penalty Interest System; Working Group on Mark to Market System, and the Technical Advisory Group on Market Surveillance. The functions of each of these committees is contained in Attachment 4.

This structure is not consistent with the organization of traditional self-regulatory organizations which usually provide a significant voice to members in its operation, but it is tilted in that direction by providing for member seats on the Executive Committee and on the various other committees. Thus, at this time it may be an acceptable variation on the self-regulatory concept especially given the popular view in India that its many exchanges are operated as private clubs for the benefit of members rather than the public interest. NSE is dedicated to departing from that mold. NSE was organized and financed by a group apparently disaffected by the other exchanges and their memberships and is interested in creating a credible marketplace in India that is nationwide in scope and which, presumably, will provide the impetus for an ultimate national market system.

Nevertheless, it is recommended that the makeup **and/or** function of the Executive Committee over time be modified in at least the following four respects each of which is directed to perfecting the self-regulatory concept: First, there should be a specific provision for listed companies to be represented thereon. The three constituencies of a securities exchange are issuers, investors and members. The latter two have been provided seats on the Executive Committee. Specific issuer representation should be added because they are an extremely important part of the operation of the Exchange. Without them there would be no product to trade.

Second, part of NSE's concept, and the direction towards which it is working, is to have members in all parts of the country. This extension has already commenced. As it continues, representation from the various regions of the country should be represented in the governing structure. Thus, it is recommended that sufficient flexibility be built into the defined structure of the Executive Committee to accommodate such. To provide for this, the country would be divided into regions and at least one person from each would be selected to represent that area on the Executive Committee. Input from the various regions would make management of the Exchange more fair and equitable. Local considerations would be factored into policy determinations made which, in many cases, may directly impact one or more of the regions. This nationwide organization cannot fairly be run out of Bombay without local input.

Third, as the membership becomes nationwide and the Exchange expands its surveillance program the number of disciplinary cases which will have to be addressed will grow. This will become a burden on the Disciplinary Action Subcommittee of the Executive Committee. To accommodate this a system of Regional Committees should be developed to address, at the initial level, disciplinary cases which arise in the region. To provide for uniformity of action, the determinations made in these cases would be reviewed by, and appealable to, the Executive Committee or the Disciplinary Action Subcommittee. As to disciplinary cases, therefore, the Executive Committee (or the Disciplinary Action Subcommittee) would be changed to that of an appellate body. The Regional Committee could also serve as policy evaluators and initiators concerning business conditions and activities in the local market and, where appropriate, would make policy recommendations to the Executive Committee. Knowledge of local nuances in the market would also be important in administration of the disciplinary process.

Fourth, the provision enabling the Central Government and SEBI to each nominate a person to the Executive Committee should in time be deleted. Government involvement in the operation of a self-regulatory organization is antithetical to the concept and could stifle initiative and creativity. The government and/or SEBI should clearly have an oversight role (and the Exchange should work closely with it in a system of cooperative regulation) but it should not participate in the operation of the organization. Nevertheless, during this period of development and expansion by NSE towards its goal of a nationwide screen based system, there may be some benefits to government participation. It is recognized that the Securities Contracts (Regulation) Act, 1956, gives the Central Government specific authority to nominate not more than three persons to the Board of an exchange. This authority is permissive, however, not mandatory, and at the appropriate time the government should be urged not to exercise it, at least as to the Executive Committee of the NSE. Ultimately, the law should be changed.

C. The Marketplace

The National Stock Exchange operates a Capital Market Segment and a Wholesale Debt Market Segment. It was authorized by the Central Government to operate as a stock exchange in April 1993 and commenced operation of its Debt Market Segment in June 30, 1994. On November 3, 1994, it commenced operation of its Capital Market Segment with trading in 200 securities comprised of the most actively traded securities on other exchanges. The Exchange's original plans were to be a debt market but this objective has changed because of inactivity in that Segment. Since its inception, the Capital Market Segment has grown rapidly. Presently approximately 1200 securities are traded, 300 of which are listed and 900 of which are authorized for trading. These latter securities are listed on other exchanges and have not yet listed on the NSE. Under the Exchange's rules, trading is permitted in securities listed on another exchange. Daily Volume in November 1994 was about 3.3 million shares traded amounting in

value to approximately Rs. 5 crore (approximately \$1.6 million). Currently volume is in excess of 40 million shares daily for a value of about Rs. 60 crore (approximately \$20 million). Transactional volume is now about 18 to 19,000 transactions per day representing, according to Exchange officials, about 25 to 30% of all transactions on all exchanges in India.

The trading system utilized to support the two trading segments is called NEAT, or National Exchange for Automated Trading. The system is screen based with automated order matching. In this order driven marketplace 98% of all trades in listed and authorized securities are automatically executed when there is a match and are locked in. The remaining 2% are permitted to be executed off the system. These are composed of large trades (in excess of Rs. 10 million) and odd lots. All off market trades are required to be reported to the Exchange within 24 hours of the trade. This is an extremely long period of time during which these trades are not reported. Greater transparency in the market would result if these trades were reported more timely, i.e., within, say, 90 seconds, certainly no more than 5 minutes, and it is so recommended. Under the current system, they are considered for volume and market closing purposes on the day reported which is not necessarily the date the transaction took place.

The Exchange presently performs its own clearing and settlement function for both of its markets but, in the near future, plans to commence operation of this function through a subsidiary clearing corporation which has already been formed. In the Capital Market Segment, settlement is characterized by short, tight and rigidly enforced settlement cycles with settlement being completed within 8 days of the last day of the trading cycle. The Exchange also has rigid procedures for handling non-performance of settlement such as short or bad deliveries. In this connection, it conducts an auction buy-in pursuant to a defined schedule so investors can be assured of cash settlement. Bad deliveries are required to be rectified within 48 hours or an auction buy-in is conducted. It has issued a publication on what are considered good and bad deliveries. It is recommended that when its clearing subsidiary is in operation, a depository is in place and the legal situation as to stock transfers has been clarified, the Exchange move toward a rolling settlement with the ultimate objective of achieving the Group of 30's recommendation of settlement on T plus 3.

In the Debt Market Segment, trades are settled on an individual basis on a settlement date specified at the time of order entry. Settlement periods ranging from same day settlement to a maximum of T+5 (six days) is permitted. Trading in this segment has been sparse.

In addition to the order driven system, the Exchange's rules authorize members to make markets in securities of their selection. Under this approach, market makers are obligated to publish bid and asked quotations and to stand ready to execute transactions in those securities at their published sizes and quotations. The Exchange's Byelaws specify that a commitment to be a market maker must be for a minimum period (unspecified) and that to withdraw from market

making 15 days notice must be given to the relevant authority and approval granted. This market maker approach has not been very successful at least in part, according to NSE officials, because of higher capital requirements imposed on market makers by SEBI. Nevertheless, if the system is retained, it is recommended that market makers be required to make a continuous market for a specified period of time once they opt to commence market making. Such would add liquidity to the market in the selected securities and provide continuity which may not otherwise be present.

NSE has rapidly positioned itself as a leading securities marketplace in India. Its activities are highly transparent with transaction and other information concerning the Exchange's securities disseminated real time over its system to all Trading Members and Participants and to others who subscribe to receive such from information disseminators. The information is currently received on in excess of about 1600 terminals of Members and Participants. Some members have multiple terminals. According to Exchange officials, the universe of non-member subscribers is not large because of the high price charged subscribers by information disseminators.

End of day transaction and other information is carried in several newspapers in Bombay and appears in newspapers in all cities where NSE has opened offices and in a number of others. In some cities they appear in more than one newspaper. The NSE Index comprised of 100 companies which, according to NSE officials, represents approximately 60% of the total market capitalization in the country has been established and is published daily. To circumvent the practice of fictitious or contrived trades being input into the system at the close to improperly establish a desired closing price, the closing price published by the Exchange is the average of the trades that took place during the last half hour of trading. While this practice appears justified on its face, it is recommended that it be reviewed by the Exchange. This review should weigh its necessity against the public's entitlement to the correct closing price.

The high degree of transparency which the Exchange has achieved is commendable and is representative of the embodiment of a properly operated marketplace and self-regulatory organization.

D. The Membership

The NSE membership is composed of Trading Members and Participants. When it commenced operations, it had 100 Trading Members. This has grown to over 550 members in the Capital Market Segment located in many cities throughout India. About 100 of these members are also members of the Debt Market Segment. In addition, there are 65 Participants. Participants are primarily large institutional customers and banks which are permitted to execute transactions directly on the Exchange through members. Members are not permitted to be engaged in any other business without permission of the Exchange. Currently, members are located in 12 cities

throughout India. Based upon applications in hand, it is expected there will be 1000 members located in 20 Indian cities by year end 1995.

The framework for member admission requirements is contained in the Securities Contracts (Regulation) Rules, 1957. In addition to the requirements contained therein, other standards have been imposed by the Exchange, most importantly, in the area of required capital. In the Capital Market, corporate members are required to have net worth of Rs. 1 Crore and minimum paid up capital of Rs. 30 Lakhs. In the Debt Market where only corporations can be members, net capital of Rs. 2 Crore is required. Individuals and partnerships are permitted membership in the Capital Market. Required net capital is Rs. 75 Lakh including the security deposit to the exchange of Rs. 35 Lakhs. Corporations in the Capital Market must deposit with the Exchange Rs. 50 Lakhs. Corporations in the Debt Market, must deposit Rs. 1.5 crore. These deposits are to provide for potential member defaults.

One problem with these capital requirements is that they are not found in the byelaws, rules or regulations of the Exchange; rather, they are found in the document entitled "Application Form and Eligibility Criteria For Trading Membership on the Capital Market Segment." Also, while the requirements are characterized in terms of "net worth," in actuality, the requirement is an adjusted net worth which, for individuals and firms, eliminates certain assets not readily convertible to cash, certain loans, value of stock exchange memberships and percentage reductions in the market value of investments, among other things. As to corporations, net worth is specified as being the lower of paid up capital plus free reserves less miscellaneous expenditures not written off and intangible assets, or total assets less fixed assets (including land and buildings), debtors outstanding for more than three months, value of stock exchange memberships, doubtful debts and advances and pledged securities. Further, there are variations from the requirements specified in the Application Form in another document entitled "Computation of Net Worth" which the staff has stated is used by inspectors in computing net worth as part of their inspections of member's operations. It is recommended that rather than the requirement being referred to as Net Worth, which it is not, that it be referred to as "net capital"; that there be only one method of calculating net capital and that it be incorporated into the regulations of the Exchange. See discussion below as to a Net Capital Rule at page 28.

Other additions in NSE's membership rules over those required by the 1957 Regulations. are that, unlike most exchanges in India, hereditary memberships (which are allowed by law), are not permitted. Also, unlike all other exchanges except the Over the Counter Exchange of India (OTCEI), the owners of a corporate member do not automatically become members of the exchange. They must come in through the regular admission procedure and be admitted on their own qualifications. NSE has many corporate memberships in the Capital Market segment and encourages such. Corporate membership is required in the Debt Market segment. There is no limitation on the number of members since trading is not floor based, hence, physical limitations

do not exist which would require such. The rules also require a member to be at least a college graduate or have an equivalent qualification.

All applicants for membership are subjected to a written examination, the syllabus of which is published, and an interview by the Membership Application Committee. According to Exchange officials, this Committee is composed of 6 persons who are not members of the Exchange or even in the securities business but are leading businessmen and citizens in the community who are appointed by the Board of Directors of the Exchange. Note: This contrasts with a statement in the Exchange publication entitled "National Stock Exchange of India Limited" that the committee is composed of "experienced people from the industry." The Committee makes recommendations for approval or disapproval of membership to the Board. Recommendations for approval may be granted outright or subject to specified conditions or actions which must be taken before unconditional membership will be granted. The Exchange takes seriously the admission procedure. In this connection, it verifies the statements made in applications and will reject those who make misrepresentations. Consistent with the concept of self-regulation, it is recommended that the Membership Application Committee be expanded to include representatives of the membership. As presently constructed, except to the extent the members thereof are investors, the self-regulatory concept is not operative. Eventually, however, it is recommended that the function of accepting applications for membership be a staff function administering objective standards. Questionable situations or rejected applications would be forwarded to the Membership Committee.

Foreign brokers are not permitted to be members of the Exchange other than as part of a joint venture with a domestic partner. There is no percentage limitation on the amount of equity which can be held by the foreign broker in the joint venture.

The additional membership requirements which the Exchange imposes in addition to those required by the official regulations are further evidence of the Exchange's commitment to operating a quality marketplace in the public interest. In addition, however, it is recommended that NSE require that all persons, especially authorized persons actively engaged in the securities business on behalf of members, take a qualification examination before they are permitted to engage in activities on behalf of the member. This would expand the number of persons required to take examinations from present requirements. It is believed, however, that it would materially upgrade requirements for entry into the business thereby adding to the credibility of the Exchange as a well regulated marketplace. Qualification examinations would test personnel on their knowledge of the capital and debt markets, their knowledge of the laws and regulations applicable thereto and the rules and regulations of the stock exchange. Longer term, consideration should be given to categorizing personnel by job function and requiring the passage of pertinent qualification examinations. At the very least, at this time the Exchange should require qualification examinations of all personnel dealing with the public.

E. The Staff

The Exchange currently has approximately 190 employees of which about 25% are technical personnel, 45% are operational personnel concerned in one way or another with the operation of the market, and the balance are secretarial and support staff. There is no discrete compliance or surveillance department and no one person is responsible for the oversight of those functions. Compliance and surveillance functions are performed by segments of various departments. Regulatory development is a function of the Capital Market and Debt Market Segment officials. Inspection of members is a function of the Membership Department where three persons are devoted to the task. Market surveillance is a function of the Capital Market Segment operations personnel in a Market Watch section. This is one of three departments in the Capital Market Segment: operations, market watch and systems development.

1. Surveillance/Compliance Department - Senior Compliance Officer

The surveillance/compliance function of the Exchange needs organization and central direction. It is an extremely important part of the Exchange's responsibility to act in the public interest and for the protection of investors. It is also important that this significance be recognized in the Exchange hierarchy. Therefore, as an immediate first step in upgrading the surveillance/compliance function, it is recommended that all regulatory, surveillance and compliance activities be gathered together into a discrete segment of the Exchange and that a full time Senior Officer be appointed to manage and build this function. This is reflected on the attached organization chart, Attachment 5, which puts the Exchange's three main functions, market operations, technology and regulation under the guidance of senior officers. This contrasts to the present organizational structure of the staff contained in Attachment 6.

2. Inspection of Members

In 1995, the Exchange commenced an on site inspection program of its members' operations. In the past several months, the inspection staff (3 persons) conducted inspections of 20 members which represented its goal for the year and complies with SEBI's requirement that 10% of the membership be examined each year. Because of the increase in membership, in the coming year 50 inspections are planned. At this rate, a member would be examined only once every 10 years. This is an inadequate surveillance effort for a self-regulatory organization. The Exchange's officials state that they are considering increasing the frequency of examinations and while a final determination has not been made, they believe it should be at least 50% each year.

Inspections are conducted using a sampling process following a check list calling attention to all of the Exchange's rules thereby assuring that all appropriate areas of the business are addressed.

The average inspection lasts about 5 days. To assist the Exchange staff, outside personnel from accounting firms and other persons who the Exchange has assured itself have experience doing similar work for SEBI are used. Prior to conducting any examinations, training sessions were held for the outsiders to assure that inspections will be conducted according to exchange desires and to assure uniformity. To further assure such, one Exchange staff person is present at all inspections. The examination team is composed of the one staff member and two outside persons. Completed examination reports are presented to the Disciplinary Action Subcommittee. No disciplinary action has been taken as yet as a result of this activity. Some members have been put on notice to correct certain problems within stated periods of time. If not completed upon a follow-up examination, the staff says disciplinary sanctions will be imposed. For this first round of inspections, the staffs intent was, at least in part, to educate members as to the inspection process, make them aware of what is expected of them and to alert them that this procedure would be ongoing henceforth.

It is recommended that inspections of the members be materially increased in number as rapidly as possible. The ultimate goal should be inspection of all members each year. In the near term, it should be no less than at least once every other year. It is also recommended that these inspections eventually be conducted entirely by employees of the Exchange without the assistance of outside auditors. This will give the Exchange greater and closer control over the inspection process and will eliminate the possibility of conflicts of interest existing between the outside auditors and the member being inspected. During the phase when outside personnel are being used, the Exchange must assure itself that no such conflicts exist, not only as to the individuals involved but as to the firm with which they are employed as well. This is fundamental and if not adhered to could seriously undermine not only the inspection process but also the perception of fairness and objectivity of the Exchange itself. A complaint was made to the Consultant during his review of the process that one of the outside inspectors was employed by a competitor of the firm being examined.

An annual inspection cycle will necessitate a substantial increase in Exchange staff dedicated to this task and an in depth focus on their training. None of these actions can be achieved overnight. It is recommended, however, that goals and a plan of action as to their accomplishment be promptly adopted.

3. *Regional Examination Staff*

Presently, the Exchange's headquarters is located in Bombay and it has offices in four other locations whose functions are devoted to clearance and settlement and assisting members. Consistent with the recommendation above that, as the Exchange expands nationwide, the country be divided into regions for representation on the Executive Committee and the creation of Regional Committees for disciplinary activities. it is recommended that each of those regions

be supported by a regional office which would be staffed by a team of inspectors who would conduct the required inspections of members' offices in the region. The staff, headed by a Manager, would also coordinate the activities of the Regional Committee. In some cases, these regional offices would in addition perform the functions similar to those of the existing four offices.

4. Market Surveillance

The concept, requirements and objectives of a properly designed market surveillance system employed by self-regulatory organizations in developed markets is contained in Attachment 7. Effective market surveillance of this type does not today exist at NSE, or in India for that matter, insofar as the Consultant is aware.

The market surveillance procedures observed at NSE deal more with trading oversight than with detecting or investigating potential market abuses such as insider trading, manipulation, marking the close or front running, though review to some degree at least for insider trading and manipulation is performed. The function is performed by the Market Watch section of the Capital Market operations staff. Five persons are dedicated to the task. They do not perform the function for the Debt Market Segment which has very low transaction volume. Staff resources are inadequate to conduct proper follow up investigations in the case of market abuses and the staff does not seem attuned to the proper method of doing so. After detailed trading information is developed as to suspected improper member activity, it is forwarded to SEBI which itself has limited resources and is governed by a law which is viewed by some as being unclear. It has been stated that this has created uncertainty on SEBI's part as to the extent of its permissible investigative activity. Unless corrected, this calls into question the viability of the entire market surveillance function in India, not only at NSE. This is being addressed by SEBI. It should be corrected forthwith or the expense and effort of developing an effective market surveillance function will be wasteful.

Market Watch's primary concern currently is to facilitate trading in an orderly manner and maintain the integrity of the system. The pursuance of this task involves a variety of activities. To illustrate, the system won't accept a transaction outside an established range. When such a transaction is entered and rejected because of this, the staff checks information available to determine if the variation is justified, such as, because of corporate action. If so, it will change the range to permit the transaction and maintain a log of the action. Also, in situations where prices go beyond the 30% intra day limit, margin of 10% to be paid to the Exchange is required of members in all transactions that were and will be executed in that security. This may be imposed for one day or for an entire settlement cycle and is designed to guard against default and to dampen speculation. If a member can't pay the margin, it is suspended. In addition, if the 30% limit is exceeded, trading is halted for at least one half hour. Various other operational

situations exist which may prevent a member from logging on to the system that are followed up on by the staff. In effect, market watch handles any kind of trading problem experienced by members.

As to market abuses, manipulation is the main concern. Insider trading and rigging are also addressed. To date, no disciplinary actions in these areas have been taken by the Exchange. The staff rightly states that proof in these cases is very difficult. It does not, however, conduct adequate follow-up investigations to develop the necessary proof and, to some degree at least, it seems to have a defeatist attitude as to developing proof of insider trading. The staff concedes its procedures are still evolving and that their experience in the area is not extensive. In reviewing for these and the other situations noted above, reports generated at 12 noon, 2 P.M. and the close at 3:30 P.M. showing the top ten stocks in price and volume variation are reviewed. Where suspicious situations are discerned, the staff talks to the pertinent members, checks news for market and company events, develops information and prepares details of situations which are not adequately explained for presentation to SEBI. They do not talk to company officials or develop other investigative materials such as copies of trading records, telephone records, call members in for on the record interviews etc. Little has been done in this area by SEBI as well, though it is in the process of investigating certain insider trading cases.

NSE is committed to developing an effective market surveillance system designed to detect market abuses. In this connection, an entirely new market surveillance system is in the planning stages and will be operated on a computer system separate from the trading system which is not now the case. This is as it should be. A Technical Advisory Group on Market Surveillance has been formed to assist in the new system's development. Coordination with this group is by the Assistant Vice President of the Capital Market Segment who has just returned from the United States where he visited Nasdaq's and the New York Stock Exchange's market surveillance departments and gained insights into their operation. While consideration is currently being given to what should be in the system, functional specifications have not yet been developed. Because the NEAT trading system automatically executes trades based on orders entered into the system, most information necessary to develop an effective market surveillance system is available. Thus, the new system should advance NSE's efforts in this area materially. Proper design is important. It is recommended therefore that a consultant experienced in such be utilized by NSE as it develops its system and that the approach suggested in Attachment 7 be followed.

Training of personnel in the proper techniques of reviewing material generated by the system and pursuing follow-up investigations is equally important if the operation of the system is to be meaningful. It is recommended therefore that appropriate NSE personnel receive detailed training in these areas. This training should be at either Nasdaq or the New York Stock Exchange since they have the most advanced market surveillance systems in the world.

Plans are that the new system be operational in approximately six months. This target is assisted by the fact that the main frame computer presently utilized for the trading system is to be converted for use as the market surveillance system. The Exchange has just accepted delivery of a new mainframe for trading. Software development will be performed locally but a request has been made for an advisor from the United States. It is highly recommended that this request be accepted.

5. *Legal Department - Corporate Secretary*

The Legal Department's responsibility does not today appear to be clearly defined. Functions within its purview are the normal functions of a corporate secretary, certain responsibilities concerning finance, accounting and audit, the arbitration program and an undefined relationship to the development of rules and regulations. It also interfaces, to some degree at least, with outside counsel. All rules and regulations do not pass through the Legal Department for review for consistency with the law and corporate policy. Some departments apparently rely extensively upon the department and utilize the assistance of its attorneys freely. Other departments, however, do not do so and do not expose proposed rules to it for evaluation. The Legal Department's involvement in the disciplinary process involves preparation of a note on a matter to be placed before the Disciplinary Subcommittee of the Executive Committee and the rendering of legal opinions as called for during the course of a hearing.

The functions of this department should be reviewed and clearly stated and emphasized to the staff. The department should be totally immersed in the rule making process. Thus, it is recommended that all rules proposals be routinely passed through it for review for compliance with law and policy and for drafting consistency. The rules and regulations in place today were obviously drafted by several people with a resulting inconsistency in format, terminology and structure. In fact, the arbitration provisions do not appear to comply with law. The Department should take the lead in redrafting them.

The head of the Department should also participate to the extent possible in committee deliberations leading to the adoption of rules and should be present at all Board and Executive Committee meetings. Presence at meetings leading to rules would enable him to insure that they are properly drafted in accordance with their intent and would assist him in being knowledgeable on all aspects of the Exchange's operation. Presence at Board and Executive Committee meetings are part of the normal functions of a Corporate Secretary and a corporation's senior legal officer. In appropriate cases, he should provide the impetus for rule making or rule amendments.

The Department's involvement in the disciplinary process should be increased and personnel involved in inspections of members should be instructed to consult with the Department for advice and guidance during the course of inspections or thereafter. Preparation of a case for

presentation to the Disciplinary Subcommittee should either be by the Legal Department or should be reviewed by it before the hearing in a matter.

In addition, the Department should coordinate involvement with all outside counsel and should manage with outside counsel all legal proceedings brought against the Exchange corporation. Its involvement in such must be active to protect the Exchange's interests because the Department will be more conversant with such than outside counsel. The Department should also be aware of and up to date on all laws and amendments thereto concerning personnel and other legal matters that a corporation must be aware of and adhere to. It should also coordinate activities with government departments and agencies.

The Legal Department serves a very important function and has significant responsibility for the proper operation of the Exchange and the corporation of which it is part. It is recommended that the Department Head be upgraded to a more senior position and his and the department's functions be made more clear. Its responsibilities should be emphasized to the staff which should feel free to consult with the Department on all matters and should be required to do so on others.

III. REGULATORY STRUCTURE

A. Byelaws, Rules And Regulations Of The Exchange

Provisions adopted by the Exchange's Board, Executive Committee or **officials** governing the operation of the Exchange and regulating the activities of its members are extensive.. They are embodied in the following documents:

1. *Byelaws*

which contain detail concerning the establishment of trading segments on the Exchange; the authorization of an Executive Committee; the Board's authority to prescribe regulations for the functioning and operation of the Exchange and the functioning and operation of the trading members of the Exchange and dealings by them; dealings in securities; the admission and qualification of trading members, the registration of "participants"; the registration and operation of market makers; transactions and settlements; margin requirements; dividends, rights and calls provisions; brokerage on dealings; brokerage on calls; underwriting commission and brokerage; sharing of brokerage; rights and liabilities of members and constituents concerning margin, defaults, and closing out contracts for failure to perform; relationships between trading members and constituents; an arbitration system; declaration of defaults by members and procedures where such occurs, and a compensation fund. The **Byelaws** are contained in a printed brochure containing only the **Byelaws**.

2. *Rules*

concerning detail as to the authority of the Board of Directors; the appointment by the Board and composition of an Executive Committee; the powers of the Executive Committee; the eligibility, qualifications, admission and privileges of trading membership; and a disciplinary procedure including provisions for penalties, suspension and expulsion. These rules are contained in a printed brochure containing only these rules.

3. *Capital Market Trading Regulations*

concerning detail as to Exchange operational matters in the Capital Market Trading Segment including dealings in securities thereon; the conduct of business by trading members; an arbitration process; records, annual accounts and audit, and provisions concerning inspections of

the operations of members. These regulations are contained in a large hard cover loose leaf book containing only regulations of the Capital Market Segment.

4. Wholesale Debt Market Trading and Listing Regulations

concerning detail as to Exchange operational matters in the Debt Market Trading Segment including dealings in securities; the conduct of business by trading members; a uniform practice code on instruments; listing regulations; an arbitration process; accounts and records, and inspections of the operations of members. These regulations are contained in a large hard cover loose leaf book containing only regulations of the Debt Market Segment.

5. Membership Application and Regulations

a booklet entitled "Application Form And Eligibility Criteria For Trading Membership On The Capital Market Segment" which, in addition to an application for membership, contains regulations relevant thereto which are not carried in any other compilation of regulations.

6. Capital Market Listing Application and Regulations

which, in addition to a listing application, contains regulations relevant thereto which are not carried in any other compilation of regulations.

7. Circulars

which are mailed to the membership as necessary concerning any matter then at hand. Many times these circulars establish substantive requirements concerning new standards of conduct by members (i.e., Code of Advertisement) or provisions governing the operation of the trading market (i.e., settlement of trades and dealings in corporate debentures). There is no organization to these documents. They are gathered together in a file or in the back of one of the loose leaf books for the market segments and they have not been incorporated into any of the other compilations of regulations.

8. Guidelines for Good and Bad Delivery

this is a booklet containing only these guidelines and are not contained in any other compilation of regulations.

A dichotomy exists at the Exchange between provisions designated as "rules," on the one hand, and "regulations," on the other. This dichotomy exists notwithstanding that both terms have substantially reciprocal dictionary definitions. It is explained by the fact that, according to

Exchange officials, only **Byelaws** and Rules are required to be filed with SEBI for approval. Regulations need only to be filed with SEBI for its information. The **Byelaws** and Rules assertedly lay out the parameters of how the Exchange will operate and be regulated. They are elaborated upon by subsequent announcements, called regulations, "as may be prescribed from time to time by the Board or relevant authority."

"Relevant authority," according to the **Byelaws** "means the Board or such authority as specified by the Board from time to time as relevant for a specified purpose." In most cases the relevant authority is the Executive Committee but it can be another Committee or designee. Using this authority, the Wholesale Debt Market Regulations, the Capital Market Trading Regulations and the other regulations described above (Circulars, membership eligibility requirements, listing requirements and Guidelines for Good and Bad Delivery) were apparently adopted.

B. Organization, Content And Scope Of Regulations

NSE has put together a significant package of rules and regulations addressing almost all areas that must be addressed by a securities self-regulatory organization. For this, it is to be commended. Nevertheless, modifications should be made because there is no central compilation, there is substantial redundancy, definition as to standards or expected conduct is many times lacking and inconsistencies exist. It is recommended, therefore, that the structure and organization of the rules and regulations be revised, and that certain of them be amended and others added. Consideration should also be given to putting proposed rules, or proposed amendments to existing rules, out for comment by the membership and industry. In markets where this is done, valuable input is received.

I. Redundancy

The Capital Market Trading Regulations and the Debt Market Trading Regulations contain many similar or identical provisions resulting in substantial redundancy. They also contain different terms in some cases when referring to the same thing, i.e., the Debt Market regulations refer to NEAT when referencing the trading system whereas the Capital Market Regulations simply refer to the Trading System. Further, certain provisions contained in the Debt Market Regulations which, while they would appear to apply, do not appear in the Capital Market Regulations (i.e., Chapter 6: Listing Regulations). It is recommended that both sets of the regulations be gathered together as Marketplace Regulations with the provisions which apply to both market segments stated only once and regulations applying particularly to one or the other of the market segments be specifically stated as such under separate headings. There is also some redundancy between the byelaws, rules and regulations and in each a similar topic is sometimes treated differently.

In all of these areas consistency of terminology and the elimination of redundancy should be strived for to add to the professionalism of the overall product and to provide greater regulatory certainty. As the NSE Manual suggested below is being developed, it is recommended that the **Byelaws**, rules, regulations, circulars and any other documents which purport to be rules or regulations be reviewed and rewritten as necessary to conform to the above recommendation.

2. Lack of Definition

In numerous areas adequate definition is not provided. To illustrate, in all categories of regulations, after a particular area is addressed, a statement is made that it "shall be subject to such terms and conditions as the exchange may from time to time prescribe," or other similar phrases. (See, for example, Capital Market Regulation 2.2.3 concerning the appointment of Users; Capital Market Regulation 3.2.6 concerning turnover limits). This occurs an inordinate number of times. Provisions such as this give the impression that the Exchange could change the provision on a whim or adopt different standards for different people. This is not to suggest that has been done but it is recommended that every effort be made to put the substantive requirement in the regulation for all to see and to eliminate this potential perception. This would not prevent changes or modifications from being made in the regulation but when the change is made the regulation should reflect such **and** be included in the NSE Manual discussed below. If this is done there would be no uncertainty by anyone as to the standards being imposed and perceptions of subjective regulation could not justifiably be raised.

3. Arbitration Code

A system of arbitration, each purportedly complete within itself, is contained in three documents: the **Byelaws**, the Wholesale Debt Market Regulations and the Capital Market Regulations. In addition to being substantially redundant, they also contain provisions which are different. It is recommended that an Arbitration Code applicable to all market segments which the Exchange may sponsor be adopted and called such. It would be made part of the Procedures segment of the NSE Manual. If the Arbitration Code is to be reprinted in other publications, it should be precisely the one there drafted without change. Certainty in the process must be assured.

It is further recommended that the Arbitration Code provide for public participation on an arbitration panel involving a customer, that three person arbitration panels, rather than one person as currently, be provided for in all but minor cases, that representation by counsel be permitted without the necessity of getting approval of the panel, that the Code or another rule of the Exchange provide that the failure by a member to promptly pay an arbitration award shall result in suspension or termination of membership, that the universe of persons from whom parties to an arbitration select an arbitrator be expanded considerably from the current 20 (60% of whom are outsiders and 40% of whom are members) and that the Arbitration Code be drafted

consistent with the Indian Arbitration Law. It does not appear to comply therewith today. Potentially, such could affect the outcome of decided cases if challenged in court.

4. Delegated Rule Making Authority

According to the **Byelaws** and Rules of NSE, regulations and rules, or amendments thereto, are required to be made by the Executive Committee or Board. The **Byelaws** state, however, that the Board may specify a "relevant authority" and assign it "such authority as specified by the Board from time to time as relevant for a specified purpose."

As stated above, as to most matters involved in the operation of the Exchange, the Executive Committee is the relevant authority and has been delegated substantial authority pursuant to the NSE Rules. However, significant authority in certain substantive areas has been delegated to the Managing Director presumably pursuant to the authority noted above. See Attachment 8A entitled "Delegation of Powers to the Managing Director Capital Market Segment Regulations relating to Trading Operations (Regulations--Part A);" Attachment 8B entitled "Delegation of Powers to the Managing Director Capital Market Segment Regulations relating to Trading Operations (Regulations--Part B);" Attachment 8C entitled "Delegation of Powers to Managing Director Wholesale Debt Market Regulations relating to Trading Operations," and Attachment 8D entitled "Delegation of Powers to the Managing Director Under Listing Regulations."

Much of the delegations of authority contained in Attachments 8A through 8D are of the type normally delegated to an exchange's staff to assist in the efficient operation of the exchange. However, in some cases authority is granted to make determinations which could be construed as substantive rule making without action by the governing bodies of the Exchange. It is recommended, that all matters which impose or change a standard of conduct, have the effect of restraining or requiring action or which otherwise modify the rights, responsibilities and obligations of members, issuers and/or investors be required to be affirmatively adopted by at least the Executive Committee. All substantive rule making should be done at that level where member, public and other input is available. It is also recommended that whenever possible generalized language like "as the Exchange may from time to time prescribe" be replaced with objective regulations governing the area concerned.

5. NSE Member Manual

In view of the above problems and that the compilation of rules is haphazard and has no central organization, it is recommended that all of the **byelaws**, rules and regulations (by whatever name) be incorporated into one "NSE Member Manual" which would be produced in hard cover, loose leaf form so it can be modified as new regulations are adopted. This compilation should be considerably smaller in size than those presently used for the two market segments which are

extremely bulky and unmanageable. One copy of this Manual would be distributed to each member. This would enable a member to consult only one source when reviewing for an appropriate rule or regulation rather than searching through many as is necessary today. The Manual should be organized by subject matter divided, perhaps, by Membership Regulations, Marketplace Regulations, Conduct Regulations and Procedural Regulations with separate sections for the rewritten **Byelaws** and Rules. The Manual should also be produced in a lesser expensive paperback form of which members could purchase multiple copies at a reasonable cost for distribution to their personnel. This publication would be revised at least once per year.

Publication of such a Manual would not negate the use of brochures containing segments of the regulations, such as the membership application booklet, but there should be one source where all rules are maintained and kept current. This is not the case today.

IV. RULES AND REGULATIONS : RECOMMENDATIONS

A. Existing Regulations

It is recommended that amendments be made as follows to the existing regulations of the Exchange:

1. General

As a general matter, it is noted that there are many provisions in the Capital Market Regulations which are not in the Wholesale Debt Market Trading Regulations though they seem applicable, and there are numerous provisions in the Debt Market Regulations that do not appear in the Capital Market Regulations though they seem applicable. Also, in both there are some provisions which are treated in more detail in one or the other when it appears the provisions could apply equally to both segments and, in other cases, there are many differences in language in regulations addressing the same subject. It is recommended that the regulations be completely rewritten to conform the provisions as appropriate in accordance with the recommendation made above in the section on Redundancy. Further, some of the comments and recommendations made below as to the Capital Market Segment Regulations apply to comparable Debt Market Segment Regulations. Those comments will not be repeated in the latter.

2. Capital Market Regulations

a. Part A -Trading Regulations

Regulation 2.2.8. (c) and (d). Eliminate the prohibition on a person being admitted as a User "against whom any disciplinary action has been taken by the Exchange or any other Stock Exchange." This is a severe penalty. It is possible that the disciplinary action may have been for a very minor infraction. It would be fairer to limit the prohibition to actions of suspension or termination of membership, or current suspensions during the term of the suspension and termination.

Regulation 3.15 This rule authorizes the Exchange to at any time restrict conditionally or unconditionally a Trading Member/Participant from dealing in a specified security. Objective

standards should applied before such action is taken with a right to be heard if the member so desires.

Regulation 3.2.1. Require the timing of orders upon receipt from the customer and upon execution. This is extremely important to the regulation of the marketplace and to the development of proof in manipulation and insider trading cases. The Exchange's examiners when conducting their inspections of member firms should be certain to verify whether orders are routinely time stamped

Regulation 4.1.1. This regulation requires that a Trading Member cannot use an office "without prior approval of the Exchange." Unless there is a reason that is not readily discernable, a member should be able to open any offices it wishes. A requirement that the Exchange be notified would be appropriate. This would not prohibit restrictions being placed upon opening new offices without approval after notification and an appropriate hearing in situations where a member's capital position is not sufficiently strong, or it has not been properly supervising its branches, or for other reasons. This procedure is followed in some developed markets.

Regulation 4.2.1. (a). The supervisory procedures specified by this regulation should be required to be in writing.

Regulation 4.2.1. (e) and (f). These provisions do not seem to fit in this rule which has to do with supervision.

Regulation 4.3.2. This rule should require that the member specifically inquire of the constituent his investment objectives and such should be required to be written on the account agreement specified in Regulation 4.3.1.

Regulation 4.4.3. This rule relates to discretionary accounts and states that any member which has such on behalf of a constituent should abide by the Securities and Exchange Board of India (Portfolio Managers) Regulations. It is questionable whether this is a well taken rule. The portfolio Manager Regulations state that a "portfolio manager" is "any person who pursuant to a contract or arrangement with a client, advises or directs or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise) the management or administration of a portfolio of securities or the funds of the client, as the case may be." "Portfolio" is stated to mean "the total holdings of securities belonging to any person." Those definitions do not seem to fit the normal discretionary account arrangement between a securities dealer and his customer whereby the customer gives him discretionary authority to execute transactions on behalf of the client. Management of the customer's entire portfolio is not necessarily involved. A rule as to discretionary accounts could specify that where discretionary authority exists, excessive transactions in size and frequency is not permitted. Such a rule is recommended at Regulation

4.5.3.(h) below.

Regulation 4.4.7. This regulation requires a customer to put in writing the cancellation of an order. This seems rather extreme, cumbersome and very inconvenient to the customer. If he is not required to put the order in writing in the first place, why should he be required to place the cancellation in writing? Also, the delay may have adverse consequences to the customer. Unless, there is some history that requires this provision, it should be rescinded.

Regulation 4.4.12. This regulation should be amended to specify that the account is specifically for the benefit of customers, that it shall be separate from any other bank account of the member and that no expenditures should be made therefrom except on behalf of the customer. It should also be expanded to provide for the segregation of fully paid securities held for customers. Also, all provisions in this area should be in one rule. Presently some related provisions are contained in Regulations 6.1.3, 6.1.4.2 and 6.1.4.3.

Regulation 4.5.1. This regulation requires trading members to at all times subscribe to the Code of Conduct as contained in the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992. It would be helpful to the membership if this Code were appended to the NSE regulations to be inserted in the NSE Manual recommended above, or even that it be adopted as an Exchange rule. Members are more likely to have at hand the Exchange's rules and regulations than the government agency's. An appendix would be more convenient to members. It may even be appropriate to give a copy of the Code to members and have them acknowledge receipt of such upon entry into membership and to sign off that they have read and comprehend it.

Regulation 4.5.3 (a). This rule should be restated and be made more explicit so as to prohibit the use of any information obtained in a fiduciary capacity for personal gain or for the purpose of soliciting purchases, sales or exchanges of securities. The reference to other laws and obligations is obfuscatory. Rephrased as suggested will state what is basic in any securities market and is an accepted principle of agency law. Most advanced markets have a similar rule and enforce similar standards of conduct.

Regulation 4.5.3 (g). This rule should be restated so as to specifically prohibit the misrepresentation in any way the nature of any transaction. Presently it does not prohibit such conduct, it only cautions that "great care" must be taken not to misrepresent etc. This is an innocuous provision.

Regulation 4.5.3 (h). This rule relating to discretionary accounts is proper as far as it goes but it should be amended to add provisions prohibiting a member with discretionary authority from effecting in such accounts transactions of purchase or sale which are excessive in size and

frequency in view of the financial resources and character of the account. Such conduct is usually referred to as “churning” and is an insidious practice which should not be tolerated in any marketplace. It should also require an **officer** or other supervisory person of the member to approve promptly in writing any order entered in a discretionary account and that all discretionary accounts shall be reviewed periodically for the purpose of detecting and preventing transactions which are excessive in size or frequency in view of the financial resources and character of the account. An after the fact review of such an account visually shows the activity therein and the official of the firm, if warranted, would make further inquiry and review to see if the rule had been violated.

Regulation 4.5.4 (b). This regulation should be clarified to make clear that the prohibition on trading in a suspended security applies whether “on or off” the Exchange.

Regulation 4.5.4 (d). See 4.5.3 (a) above. This rule is more all inclusive than 4.5.3 (a) but it still does not go far enough. It does not prevent the misuse of any information obtained in a fiduciary capacity for any purpose which it should. These rules should both be eliminated completely and be replaced by the rule as suggested in 4.5.3 (a).

Regulation 7.1.1. This regulation should be amended to provide that when outside professionals are to be used in an inspection care be taken to insure that none of them or their employers have a conflict of interest or that their employer is not a competitor of any of the members to be examined. As stated above, a complaint to this effect was made to the Consultant during his review of the process by a member.

Regulation 7.1.2 One of the primary purposes of inspections of members is to determine if they are in compliance with capital requirements. Failure to be in compliance puts customers and other members at an additional risk unknown to them at the time of dealing with the errant member. This review is not mentioned in the list of purposes of the inspection contained in this regulation. It should-be added at the very beginning.

Regulation 7.2.1. Prior notification to members of inspections to be conducted by the Exchange’s inspectors should be eliminated. A member’s books and records should be current and properly maintained and its operations properly conducted at all times. Notification gives the opportunity to alter records which may not be in total compliance to give the appearance of compliance, or to otherwise obfuscate things. Thus, the standing rule should be that there no prior notification of inspections.

Regulation 7.3. The regulation should be amended to provide for immediate suspension of a member who refuses to cooperate with the inspectors by refusing them admission or refusing access to the books and records, making access difficult or for other reasons which may be

identified. This should be **carefully** written so that it cannot be taken advantage of by the Exchange or its inspectors.

Regulation 7.4.3. (a) This regulation relates to taking action on the inspection report and specifies that after consideration by the Exchange notice will be communicated to the member of the findings and he will be given an opportunity to be heard before any action is taken. Notwithstanding that, subsection (c) says where the Exchange is of the opinion that no such hearing should be provided, in certain circumstances it may take action forthwith without giving an opportunity of being heard. These provisions and the provisions of Part IV of the NSE Rules should be amended to afford a greater measure of due process to a member who has been accused of a violation of the Exchange's rules or regulations or other wrongdoing. That process should involve a notice of the allegations made, the right to respond to the charges, the right to a hearing and representation by counsel before a determination is made that a violation has occurred and that the determination be in writing. According to Part IV, Section (12) of the Rules, representation by counsel is now permitted only if authorized by the relevant authority. In order to eliminate a cumbersome procedure in the case of minor violations, procedures could be developed for a simplified procedure but which would still **afford** the respondent a hearing if he so desired. In pursuance of the self-regulatory process, hearings should always be before a panel composed predominately of the accused's peers, not before the staff or others.

b. Annexures to Part A -Trading Regulations

Annexure 2. Contract Note. The details of the required data on the face of the contract note are entirely adequate but much of the detail on the reverse side concerning arbitration is unnecessary. On the face of the note, a statement is made that the contract note constitutes an agreement that the arbitration provisions of the Exchange will govern in the **event** of a dispute. That and a reference to where those provisions can be found is all that is necessary. This will eliminate much of the verbiage on the reverse side of the note.

Annexure 3. Member and Constituent Agreement. Section 1) of this agreement requires at least a one month notice to terminate. This seems excessive. Why can't a constituent terminate his account with a member whenever he desires? This agreement should be amended to reflect such.

c. Part B - Clearing and Settlement

Regulation 7.13.2. Dispute Resolution and Arbitration. It is recognized that a speeded up procedure is necessary for settling the kind of dispute to which this provision relates. However, the effect of it is to add a new provision to the arbitration procedures which are spelled out elsewhere. This provision should be in the Arbitration Code recommended above which could

be referred to at this point in the regulations.

d. Capital Market Circulars

Circular dated 15/03/95. This circular in pursuance of certain specified regulations announces the commencement of a new trading segment named Trade for Trade. The provisions are substantive and should be incorporated into the regulations at the appropriate place.

Circular dated 07/12/94. This circular in pursuance of certain specified regulations specifies penalties which will be imposed in certain situations. The provisions are substantive and should be incorporated into the regulations at the appropriate place.

Circular dated 27/12/94. This circular amends Rule IV, section 5 (h) of the NSE Rules concerning advertisements and communications and establishes a Code of Advertisement which was attached thereto. These provisions are substantive and should be incorporated into the Regulations at the appropriate place. It is recommended that this Code be rewritten to make more definitive prohibited or restricted conduct. Thus, the word “shall” would be used in many cases where the word “should” is used.

Circular dated 06/02/95. This circular clarifies the Advertisement Code and adds provisions relating to definitions. It should be incorporated into the Regulations at the appropriate place.

Various Circulars Distributed on Other Dates. There are a number of other Circulars distributed by both the Capital Market Segment and the Wholesale Debt Market Segment which contain substantive provisions that should be incorporated in the regulations at the appropriate places.

3. Wholesale Debt Market Trading Regulations

Regulation 4.5.3.(j). This regulation requires a Trading Member to always place a constituent's orders before its own. This rule is basic to the responsibilities and fiduciary obligations of a stockbroker to a customer but it does not appear in the Capital Market Segment Regulations. It is recommended that it be expanded, however, to prohibit such trading by the member either personally or on behalf of the firm and that the same restriction apply to transactions by any member of the firm or employee thereof or the execution by them of an order on behalf of a member of their immediate family when a constituent's order is in hand.

Regulation 6.7. This provision states that continuous listing requirements “shall be as laid down in the listing agreement and shall also be subject to such other terms and conditions prescribed by the Exchange from time to time.” These requirements should be specified in the regulations

notwithstanding that they also appear in the listing agreement. Those which appear in the listing agreement should be more clearly stated and expanded to include illustrations of other events that are usually found marketplace rules which should be the subject of such a notice, such as, any changes in the company's corporate purpose and any material alterations in the company's activities or the initiation of new ones; disposition of a significant part of the company's fixed assets as per the last balance sheet; resignation or removal of members of the Board or management; losses of a significant part of the company's net worth; a significant labor dispute; acquisition or loss of a significant contract; a significant new product or discovery; facts of any nature that materially affect or might materially affect the economic, financial or equity situation of those companies controlling, or controlled by the company, among others.

a. Listing Regulations

There are a number of provisions in the Listing Regulations, usually referred to as continuing listing requirements, which impose on listed companies the obligation to inform the Exchange of various material matters such as any change in the company's directorate by death, resignation, removal or otherwise; in the managing director or the auditor appointed to audit the books and accounts of the company, and other matters, but there is no requirement that notification be given to the public. It is recommended that the Exchange require that those material matters that would have the effect of impacting an investor's investment decision be timely given to the public and that the Exchange be notified of such at the same time. It is also recommended that these requirements be incorporated into the regulations and that illustrations of the types of events which the Exchange and the public should be put on notice of be expanded to include others usually found in marketplace rules. See comment on Regulation 6.7. of the Wholesale Debt Market Regulations.

B. Proposed New Regulations

It is recommended that at least the following new regulations be adopted by the NSE:

Net Capital Rule--The net worth rule should be designated as the "net capital rule" and provisions should be added specifying that the debt/capital ratio of a member shall not exceed 15 to one; requiring the filing of monthly summary financial statements with the Exchange; requiring that the member notify the Exchange if its capital falls below requirements, and that if such occurs the member be immediately suspended until he again brings himself into capital compliance. See also the comment made above in section on "The Membership."

Order Ticket Rule--Such a rule would complement other rules discussed above concerning order tickets and confirmations and would require members in connection with the execution of orders to enter on the order ticket for the transaction whether he is acting as agent or principal. This

requirement is important for surveillance purposes.

Rule Re: Influencing or Rewarding Employees of Others-This rule would prohibit gratuities of any kind, in excess of nominal amounts, being given by a member **firm** to employees of another firm where such is in relation to the business of the employee's employer. It would be designed primarily to prevent payments by one firm to employees of another to induce the channeling of orders or other information of his employer to the first firm. An amount of Rupees per year per individual that would be considered nominal would have to be determined by the Exchange.

Charges for Services Performed-Fair Prices and Commissions-This rule would require that all charges made by brokers and dealers be reasonable and not unfairly discriminatory between customers. It would also insure that when a broker or dealer is buying from a customer for his own account or selling to a customer from his own account that the price be fair taking into consideration various factors including market conditions and his entitlement to a profit. The rule would also specify that when a broker or dealer is acting as agent for a customer he charge the customer no more than a fair commission or service charge taking into consideration similar variables including any service he may have rendered by reason of his experience in and knowledge of the security and the market therefor. This proposal would have to be weighed against the Exchange's present rules which specify the amount of commission which can be charged and a **determination** made as to which is better. The rule further emphasizes the basic principle that customers in securities transactions must be treated fairly.

Prohibition on Publication of False Quotations-This rule would prohibit the publication of false quotations or transactions for any purpose. This is important to curtailing manipulations and emphasizes the Exchange's commitment to operating an orderly and honest market.

Prohibition on Extreme Quotations.-- This rule would prohibit members from selling securities below, or buying them above, the market, with the manifest purpose of recording an extreme quotation. The rule is important to market integrity and to assist in preventing manipulations.

Prohibition Against Payments to Influence Market Prices-The purpose of this rule would be to prohibit payments to anyone to encourage the publication in any newspaper or other medium of any matter intended to have an effect on the market price of a security. This is another market manipulation prevention rule since articles in newspapers, especially those of general circulation, can have a direct impact on the interest in and demand for a security. This would not effect bona fide articles about companies which were not encouraged by the payment of something of value.

Prohibition on Publication of Fictitious Transactions and Wash Sales--This regulation would prohibit members from making fictitious sales or publishing fictitious bids or offers for securities and from executing an order for the purchase or sale of securities which doesn't involve a change of

ownership. These regulations would further add to the integrity of the market by preventing activity which has no valid purpose

Rule Concerning Proxies-This regulation would prevent a member from giving any proxy, consent or authorization, in respect of any security carried for the account of a customer, to a person other than the customer, without the express written authorization of such customer.

Separation of Personnel-This regulation would require a member to notify the Exchange of the suspension or dismissal of any employee or officer for cause. It would complement the Exchange's inspection program and would trigger an inquiry of the member to ascertain the specifics of the cause for the termination and perhaps further investigation. It is recommended that a form be developed for this purpose which would require among other things disclosure of the reason for the termination.

Rule Requiring Sending of Customer Account Statements-This rule would require the mailing quarterly of account statements to customers whose accounts have a security position or money balance or in which there has been activity during the previous quarter. Activity would be defined to include, but would not be limited to, purchases, sales, interest credits or debits, dividend payments, transfer activity, securities receipts or deliveries, and/or journal entries relating to securities or funds in the possession or control of the broker or dealer. Such a requirement would enable customers to be constantly put on notice of what the broker's or dealer's records reflect in the customer's account. It would also enable the customer to compare the statement with his own records for purposes of accuracy and to put the broker or dealer on notice if there is a discrepancy.

Rule Requiring Compliance Departments/Officers/Supervisory Procedures-Securities firms in India do not normally have compliance departments or compliance officers. Nevertheless, the Exchange should seriously consider requiring that all firms have an organized compliance function whether in a separate department, or otherwise. Written supervisory procedures should also be required for monitoring the activities of personnel engaged on behalf of the member in securities activities, especially those who are dealing with the public. The supervisory procedures would be administered by a compliance officer who would be responsible for administering the compliance function. The size of the firm is immaterial to the implementation of this recommendation.

Rule Requiring Reports of Non-Compliance-This rule would require members to report non-compliance with rules by members' employees to the Exchange or SEBI, or both. This procedure would have the effect of alerting the Exchange and the Commission to possible problem persons and create a discipline in firms to surveil the activities of personnel.

Rule Concerning Fidelity Insurance-The Exchange's Byelaws currently require the maintenance of a compensation fund. It is recommended that, as an alternative thereto or in addition thereto, the

Exchange consider a rule requiring member firms to maintain fidelity bonds protecting customers against the potential infidelity of their employees. The availability of such insurance in India would have to be assessed.

V. COMPLIANCE AND DISCIPLINARY MECHANISM

Rules alone cannot do the job. A mechanism to enforce those rules and to discipline violators is also necessary. Thus, initially a compliance capability must exist which is reasonably designed to detect improper conduct. The Exchange has embarked on such with the initiation of its inspection program and improvement of its market surveillance capability. Other programs should also be added such as customer complaint, termination for cause and examination for cause programs. The Exchange also has a disciplinary mechanism but it must be improved. It is recommended, therefore, that such programs be established and improvements made as discussed hereafter..

A. Customer Complaints /Terminations For Cause

Much regulatory intelligence is obtained from a review and follow-up on customer complaints and investigations into the reasons behind the termination of personnel by member firms for cause. As to customer complaints, it is **recommended** that if the volume warrants, a person or persons should be dedicated to this task by the Exchange. Their function would be to review all customer complaints received and to follow up on them when warranted. In appropriate cases, full investigations would be conducted. Customer complaints are often the tip of the iceberg as to member improper conduct.

Equally important is requiring members to notify the Exchange when a person is discharged. This was discussed above. **Termination** for cause notices would be followed up in the same manner as customer complaints. It may be that a **person** had been discharged for taking advantage of a customer or another member. If so, the **person** should be appropriately disciplined or expelled **from** the industry to prevent him from doing the same thing at some **future** date to other customers or members. His actions may also be symptomatic of problems inherent in the operation of the member.

B. Cause Examination Program

To complete the Exchange's surveillance and compliance program, when the situation dictates, a segment of the staff should be dedicated to what could be referred to as "cause" examinations, that is, the investigation of more serious matters such as fraud, manipulation, insider trading and rigging, among others. Impetus for such investigations would come from revelations found in routine inspections, from customer complaint and cause examinations, from market surveillance, from other

market information or from other sources. Specialized training in these areas will be required from experienced investigators who have engaged in such investigations in other countries, in particular, the United States. This would enable these personnel to learn from experienced professionals successful investigative and prosecutorial techniques thereby enabling more effective investigations in these important areas. The Exchange can be of material assistance to SEBI in conducting these investigations to the point where they have to be handed off to it. Knowledge that it is being done will have a prophylactic effect on market participants and will add to the credibility of the Exchange as a well regulated marketplace.

C. Disciplinary Mechanism

To impose sanctions on wrongdoers, an effective disciplinary mechanism must be in place. Such a system should be structured for efficiency and afford respondents adequate due process. Thus, it would provide for notification of the charges brought, the opportunity to respond, the right to a hearing and the right to representation by counsel. Some kind of appeal mechanism should also be provided for respondents dissatisfied with the findings of the body with original jurisdiction. The Exchange has the beginnings of such a system but it is inadequate. It is recommended that it be improved and defined in detail as part of the Exchange's regulations.

VI. STAFF TRAINING

Important to the success of the Exchange in developing a credible marketplace, having efficient and effective enforcement and disciplinary mechanisms and operating as a true self-regulatory organization is a highly professional, thoroughly trained staff particularly in specialized areas such as insider trading and manipulation investigations, the structure and operation of a periodic examination program and the operation of a market surveillance system. It is recommended that training in these areas be obtained in countries that routinely perform these functions and are highly experienced in their operation, most probably in the United States. This cannot be emphasized too strongly.

VII. CODE OF CONDUCT

A self-regulatory organization has a special responsibility to have an established internal Code of Conduct governing the activities of its employees. The necessity for such is emphasized by the nature of their activities which are often sensitive in nature and involve the handling of confidential or market sensitive information.

It has been said that the rules pertaining to employees of self-regulatory organizations must go beyond those of the regulated in order that the integrity and credibility of the organization as well as its reputation for fair dealing is not compromised. In this connection, it is important that employees maintain exceptionally high standards of honesty, integrity and impartiality in their conduct. It is also important that they have a conscious awareness of the need to avoid situations which could result in actual misconduct or conflicts of interest or those most likely to raise an appearance of impropriety, and to conduct themselves in their professional and personal relationships in a manner which commands the respect and confidence of both the securities industry and the public.

To avoid even the perception of unfairness in the discharge of their activities, therefore, it is recommended that internal standards be developed detailing what is expected of employees in a variety of areas, such as, **conflicts** of interest, confidentiality of information, business dealings with others especially those in the industry, securities transactions, outside or private employment and the acceptance of gifts or gratuities, among others.

In making this recommendation, it is recognized that the Exchange has adopted requirements relating to employee conduct. However, it is conceded by its officials to be inadequate. It should, therefore, be discarded and a new more comprehensive Code of Conduct written. This should be done forthwith.

VIII. CONCLUSION

The NSE has made considerable progress toward its objective of creating a transparent, credible marketplace and becoming an effective self-regulatory organization. Much needs yet to be done, however. Of significant importance is planning a governance and corporate structure designed for the time the Exchange becomes a truly national organization and which gives members a greater voice in its governance and operation pursuant to a system which does not enable it to become a "private club" operated for the benefit of members rather than the public. Also, the Exchange's compliance, surveillance and disciplinary mechanisms must be perfected, specialized staff training accented, the arbitration program improved and its rules made more orderly and comprehensive as recommended above.

All of this cannot be accomplished overnight, but it is strongly recommended that efforts be immediately undertaken to develop a plan to achieve such with target dates and deadlines to be met. It is recommended that a committee representative of members, issuers and the public, with strong staff support assigned, be created for this purpose.

ATTACHMENTS

1. List of Persons Interviewed
2. Concept Paper on Self-regulation
3. List of Promoters of the National Stock Exchange of India Ltd.
4. List and Functions of Committees of the National Stock Exchange of India Ltd.
5. Concept Paper on Requirements and Objectives of Properly Designed Market Surveillance System
6. Proposed Organizational Structure for National Stock Exchange
7. Present Organizational Structure of National Stock Exchange
8. Document Re: Delegated Authority to Managing Director of the National Stock Exchange

ATTACHMENT 1

PERSONS INTERVIEWED

1. Dr. R.H. Patil, Managing Director, NSE
2. Mr. Ravi Narain, Deputy Managing Director, NSE
3. Mr. Raghavan Putran, Vice President, Capital Market Segment, NSE
4. Ms. Chitra Ramkrishna, Vice President, Debt Market Segment , National Stock Exchange
5. Mr. Ashishkumar Chauhan, Assistant Vice President, Capital Market Segment, NSE
6. Mr. K. Kumar, Assistant Vice President, Membership Department, NSE
7. Mr. J. Ravichandran, Company Secretary and Assistant Vice President (Legal), NSE
8. Mr. Ajay Sikri, Manager (Operations- Market Watch), NSE
9. Mr. R. Sundara Raman, Assistant Manager, NSE
10. Mr. Neeraj Kulshrestha, Assistant Manager, NSE
11. Mr. D. R. Mehta, Chairman, securities and Exchange Board of India
12. Mr. L. K. Singhvi, Senior Executive Director, Securities and Exchange Board of India
13. Mr. R.V. Nabar, Division Chief, Securities and Exchange Board of India
14. Mr. R. Chandrasekaran, Managing director, Stock Holding Corporation of India Limited
15. Manoj Borkar, Company Secretary, Stock Holding Corporation of India Limited
16. Mr. S. Venkiteswaran, Senior Advocate. Legal Advisor to NSE and Member of Board of Directors
17. Mr. Madhur Murarka, Director, Mata Securities India Pvt. Ltd. (Member, NSE)

18. Mr. M. K. Khanna, Chief Executive Officer, UTI Securities Exchange Ltd. (Member, NSE)
19. Mr. Ajay Shah, President, Centre For Monitoring Indian Economy Pvt. Ltd., Chairman, NSE Technical Advisory Group on Market Surveillance

ATTACHMENT 2

SELF-REGULATION IN THE SECURITIES INDUSTRY

A. THE CONCEPT

A fundamental premise in the concept of self-regulation is protection of the public interest. Inherent in this premise is that a self-regulatory organization cannot operate for the primary benefit of the members of the organization. Its thrust, therefore, and its guiding principle must be the public interest and the protection of investors.

For self-regulation to be successful it must have the total support of the government hopefully evidenced by a statutory grant of authority, or regulatory mandate, which also specifically delineates the responsibilities and obligations of the self-regulatory organization or organizations and mandates that all securities organizations doing business with the public be members thereof.

Important in the successful implementation of the self-regulatory concept is close government oversight effectively, efficiently and fairly administered, but not direct government involvement in the self-regulatory organization as this could stifle initiative and creative thinking. In some countries, including India, government representation on the governing Board of a self regulatory organization is either required or authorized. Long term this is not advisable and is antithetical the concept of self-regulation. However, in certain transitional situations, it may serve a short term good.

In addition, self-regulation in the generally accepted international context embodies the premise that members of the industry set standards for their business conduct for the purpose of enhancing their industry's professionalism and stature in the eyes of the public. It also embodies the enforcement of those standards and other provisions of law on members of the industry by their peers. Standards established by self-regulatory organizations often go beyond the illegal and establish ethical norms which must be observed. Significant, however, is that these rules and other standards adopted are for the most part formulated by professionals knowledgeable in the nuances of the securities business, presumably experts in the subject area, though government approval is required in most countries. Sanctions imposed can, depending upon the severity of the violation, bar a firm from further involvement in the securities industry. Important here is that peers of the accused, who are schooled in the ways of the market, sit in judgment.

As stated, for the effectiveness of the self-regulatory concept to be maximized, it should have a legal framework established by a statute or regulatory sanction which establishes and defines the

functions, authority and limitations of its regulatory authority and lays out the relationship between the SRO and the government regulatory authority. It is most important, however, that there be government they should work together is a spirit of cooperation.

Self-regulatory organizations may be organizations which are both regulators and market operators (the United States mode) or those whose purpose and function is only regulation (the United Kingdom mode). The former are usually exchanges or operators of organized markets. The latter are sometimes called securities associations. Either concept is viable and has worked successfully in those countries. Even when the functions are separated, market operators are still self-regulatory organizations in respect to the operation of their market places. This is the case in the U.K. where market operators are not self-regulatory organizations but they have the indicia of such in overseeing their markets.

B. RULES OF SELF-REGULATORY ORGANIZATIONS

Generally, rules of self-regulatory organizations are divided into admission rules, marketplace rules, conduct rules and procedural rules.

1. Admission Rules

Admission rules govern the entry of persons or firms into the securities business and many times involve the passage of written qualification examinations to insure professional fitness before a person is permitted to conduct a securities business. These are sometimes tailored to the function which the individual wishes to pursue in the industry, that is, **salesman**, trader, principal of a firm, among others. The self-regulatory organization determines the content of the qualification tests and to insure that the content is in keeping with the times, test modules are routinely updated. Admission standards could also impose educational, age, experience or other requirements generally, or on certain categories of employees, or create additional standards for **firms**.

For securities firms, admission and continuing qualification standards for **firms** often involve capital and books and record keeping and maintenance requirements set by the government or the self-regulatory organization. Even when set by the government they are often enforced by the self-regulator. The self-regulator may even wish to set stricter capital standards for **firms** engaged in certain kinds of more risky business or for other reasons.

2. Marketplace Rules

Marketplace rules govern the operation of exchanges or organized markets and are usually

divided into listing rules including continuing compliance standards, trading rules (including requirements relating to customers such as time stamping orders when received and the sending of **confirmations** as to each order), rules insuring transparency in the market, and clearance and settlement requirements. Also, there are often rules governing the primary offerings of securities.

Listing rules vary with the marketplace and may establish different standards for a main board and a second board. Continuous disclosure requirements mandate the disclosure by listed companies of certain information on a periodic and other basis after listing. This includes periodic reports and reports concerning material events. Trading rules govern trading on the market. These are important to the price discovery and trade execution process and to protect against manipulation and other improper trading practices.

Systems are maintained for disseminating quotations and last sale data and for processing transactions. This insures transparency in the marketplace for the benefit of the public and investors. Marketplaces also normally have rules governing clearing and settlement practices. Some **SRO's** operate their own clearance and settlement systems. Others do it in coordination with outside organizations such as clearing corporations, often owned by one or more **self-regulatory** organizations or banks.

Marketplaces should have in place an effective, automated market surveillance system. These systems, usually referred to as stock watch systems, are designed to monitor the market for unusual price or volume movements. Their purpose is to raise red flags as to the possibility of insider trading, manipulation or other improper trading activity such as frontrunning and marking the close. They also provide an audit trail of activity of all securities in the market. These systems are considered extremely important to have in place in advanced markets and are considered an essential element of effective regulation. Their operation is based 'upon the input of quotation, transaction and other information required by trading and other rules governing the marketplace. In evaluating "red flags" that are raised, this information is analyzed in combination with other company specific and market information to determine if an investigation should be pursued.

3. Conduct Rules

Conduct rules establish generally acceptable business practices for firms and their employees in dealing with their customers, securities firms and other organizations. These involve standards relating to suitability, best execution, churning, fairness of markups/markdowns and commissions, unauthorized transactions, disclosure of interest in certain situations, prohibitions on guarantees against loss, communications to the public, customer priority when a dealer is dealing in the same security and supervision practices of firms, among other things. More egregious practices are also covered such as false trading and rigging transactions.

manipulations, false or misleading statements, fraudulently inducing persons to deal in securities, use of manipulative and deceptive devices, dissemination of information about illegal transactions and insider trading, among others. Many times certain of these practices are direct violations of law and in many countries violations of criminal law.

Self-regulatory organizations often have requirements that its member firms have internal procedures to insure proper supervision of the activities of their employees, in particular those dealing with the public. This often includes a requirement that firms have a Compliance Director who is responsible for the proper implementation of these procedures.

4. *Procedural Rules*

Procedural rules can be of several types, the most common of which are surveillance and disciplinary procedures, arbitration procedures and procedures for the operation of systems which the self-regulatory organization may have in place. Surveillance, disciplinary and arbitration procedures are discussed below.

C. *SURVEILLANCE AND DISCIPLINARY MECHANISMS*

1. *Surveillance Mechanism*

In addition to the establishment of rules, a self-regulatory organization must establish a system to surveil for compliance with the rules established and other laws and regulations governing the securities industry. Thus, it must have an enforcement mechanism. This function involves, in addition to an automated market surveillance system, routine on site and cause examinations of member firms' operations. Routine examinations are conducted pursuant to a prescribed format, perhaps modular in nature, and cover all aspects of a firm's operations including compliance with financial and books and records rules, trading rules, conduct rules, supervision rules of the organization and the rules established by the government regulatory authority. Any other area of the member firm's business considered pertinent would also be reviewed. Routine examinations would be periodic, perhaps no less frequent than once per year. Cause examinations would be conducted as necessary as a result of complaints or other indications of improper activities coming to the attention of the self-regulatory organization, perhaps as a result of the operation of the market surveillance system.

Findings of noncompliance would result in disciplinary procedures being pursued against the violator and in cases where wrongdoing is found, sanctions imposed. The important point to stress here is that rules alone do not make for a well regulated market. There must also be a process in place which enforces those rules and which is able to identify and sanction those who do not follow them. A market that is not well regulated is not a credible marketplace, and

without credibility a marketplace has little to offer. On the other hand, a well regulated market, one not operated for the primary benefit of its members, will have a better chance of attaining high credibility and international acceptance .

2. Disciplinary Mechanism

To impose sanctions on wrongdoers, an effective disciplinary mechanism must be in place. Such a system should be structured for efficiency and afford respondents adequate due process. Thus, it would provide for notification of the charges brought, the opportunity to respond, the right to a hearing and the right to representation by counsel. Some kind of appeal mechanism should also be provided for respondents dissatisfied with the findings of the body with original jurisdiction.

To have efficient and effective enforcement and disciplinary mechanisms a highly professional, thoroughly trained staff is essential. Training should be obtained in countries that routinely perform these functions and are highly experienced in their operation. This cannot be emphasized too strongly.

D. ARBITRATION PROCEDURE

The establishment of a fair dispute resolution system is an important complementary process to the regulatory function of a self-regulatory organization. An arbitration procedure is designed to adjudicate finally disputes between members and the public, and between members and other members, without the necessity of going to court. Arbitration programs have worked very effectively at self-regulatory organizations in advanced markets and are considered an important service to members. Important here is that the arbitration system be available not only to members of the self-regulatory organization but also to customers who may have grievances against the firm or person with whom they have done business. The procedures established must also be fair, allow public representation on an arbitration panel in cases of customer arbitration and permit representation by counsel. Determinations should be final with little or no opportunity for appeal absent some egregious situation such as demonstrable fraud on the part of the arbitrators. In this connection, the arbitration code adopted should be consistent with the Arbitration Law of the country of domicile

E. CODE OF CONDUCT

A self-regulatory organization has a special responsibility to have an established internal code of conduct governing the activities of its employees. The necessity for such is emphasized by the nature of their activities which are often sensitive in nature and involve the handling of

confidential or market sensitive information.

It has been said that the rules pertaining to employees of self-regulatory organizations must go beyond those of the regulated in order that the integrity and credibility of the organization as well as its reputation for fair dealing is not compromised. In this connection, it is important that employees maintain exceptionally high standards of honesty, integrity and impartiality in their conduct. It is also important that they have a conscious awareness of the need to avoid situations which could result in actual misconduct or conflicts of interest or those most likely to raise an appearance of impropriety, and to conduct themselves in their professional and personal relationships in a manner which commands the respect and confidence of both the securities industry and the public.

To avoid even the perception of unfairness in the discharge of their activities, therefore, internal standards should detail what is expected of employees in a variety of areas, such as, conflicts of interest, confidentiality of information, business dealings with others especially those in the industry, securities transactions, outside or private employment, the acceptance of gifts or gratuities, and other activities.

ATTACHMENT 3

PROMOTERS OF NATIONAL STOCK OF EXCHANGE OF INDIA LIMITED

1. INDUSTRIAL DEVELOPMENT BANK OF INDIA
2. LIFE INSURANCE CORPORATION OF INDIA
3. GENERAL INSURANCE CORPORATION OF INDIA AND ITS SUBSIDIARIES
4. INDUSTRIAL FINANCE CORPORATION OF INDIA LTD.
5. INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA LTD.
6. STATE BANK OF INDIA
7. BANK OF BARODA
8. CANARA BANK
9. PUNJAB NATIONAL BANK
10. CORPORATION BANK
11. INDIAN BANK
12. ORIENTAL BANK OF COMMERCE
13. UNION BANK OF INDIA
14. SBI CAPITAL MARKETS LTD.
15. STOCK HOLDING CORPORATION OF INDIA LTD.
16. INFRASTRUCTURE LEASING AND FINANCIAL SERVICES LTD.

ATTACHMENT 4

COMMITTEES OF THE NATIONAL STOCK EXCHANGE

1. The **Executive Committee** - for managing the overall day-to-day operations of the Exchange. The powers as specified in Clauses 4, 5, 6, 7, 8 of Chapter II of the Rules of the Exchange have been delegated by the Board to the Executive Committee. The main powers of the Executive Committee are as follows :
 - (a) approving securities for admission to the relevant Official List for NSE securities;
 - (b) admitting trading members;
 - (c) approving, in the case of capital market trading segment, market-makers to act as such;
 - (d) supervising the market and promulgating such Business Rules and Codes of Conduct as it may deem fit;
 - (e) determining from time to time, fees, deposits, margins and other monies payable to the NSE by trading members and Companies whose securities are admitted / to be admitted to the **Official** List and scale of brokerage chargeable by trading members;
 - (f) prescribing, from time to time, capital adequacy and other norms which shall be required to be maintained by trading members;
 - (g) prescribing, from time to time, and administering and effecting penalties, fines and other consequences, including suspension / expulsion for defaults or violation of any requirements of the **Byelaws** and Regulations and the Rules and Codes of Conduct and criteria for readmission, if any promulgated thereunder;
 - (h) administration, maintenance and investment of the corpus of the Fund(s) set up by the Exchange, including Compensation Fund;
 - (i) norms, procedures and other matters relating to arbitration;
 - (j) power to take disciplinary action / proceed legally against any trading member;

- (k) dissemination of information, announcements to be placed on the quotation system;
 - (l) listing requirements and conditions to be complied with;
 - (m) listing fees payable by the company whose securities are admitted to dealings on the Exchange;
 - (n) continuance of listed status of the company whose securities are admitted to dealings on the Exchange;
 - (o) any other matter delegated by the Board.
2. **The Membership Approval Committee** - for recommending the selection of members on the Wholesale Debt Market and Capital Market segments of the Exchange on the basis of admission criteria for Wholesale Debt Market and Capital Market membership as approved by the Board of Directors.
3. **The WDM Trade Settlements sub-committee of the Executive Committee** - for taking decisions relating to deferring of settlement, modifications of trade terms, cancellation of trade, disabling trading members and participants in case of serious trade or settlement disputes from further access to the trading system and other matters relating thereto.
4. **The Committee for identifying good and bad delivery of Securities** - for preparing a manual of good and bad deliveries of Securities, to serve as a guideline for Post Trade Clearing proceedings and to add further norms regarding good and bad deliveries, as may be necessary, from time to time. As the existing guidelines did not encompass all the possible cases of bad deliveries especially in case of new instruments being introduced in the market from time to time and as there was no comprehensive authentic document giving various cases of good and bad delivery which could be referred to by trading members and exchange officials, this Committee was formed for preparing a manual of good and bad deliveries of Securities.
5. **The Advisory Committee on listing of securities** - for advising NSE on listing of the securities of the companies. The Committee would advise NSE on the following matters:
- (a) the suitability of the companies for listing on the Exchange within the parameters set out by the listing agreement;
 - (b) to ensure that the applicant company has complied with all the conditions set out

in the listing agreement as well as other formalities, SEBI Regulations etc.

(c) to advise NSE on systems and procedures to be adopted for listing of securities.

6. The **Disciplinary action sub-committee of the Executive Committee** - was formed as the Relevant Authority to decide on the disciplinary action to be taken under Section IV of the Rules of the Exchange for any contravention, non-compliance, misconduct, unbusinesslike or unprofessional conduct, etc. by a trading member as mentioned in Section IV of the Rules of the Exchange.
7. The **Committee for Accounting Norms** - for evolving uniform accounting norms / standards / practices for trading members so as to ensure better compliance by trading members.
8. **Working group on penalty point / penalty interest system** - A penalty point / penalty interest system in respect of Capital Market segment was in operation to reduce incidence of bad delivery of documents as well as to restrict shortages and delays in delivering documents to the Clearing House. However, the system had become a deterrent to the trading members due to its perceived severity. Many trading members had therefore requested a review of the system of penalty point / penalty interest. In view of this, a Working Group was appointed to suggest changes in the existing system of imposing penalty points / penalty charges.
9. **Working group on mark to market system** - to suggest a suitable mechanism and procedure for evolving and implementing mark to market.
10. **Technical Advisory Group on Market Surveillance** - to work out the modalities for market surveillance.

ATTACHMENT 5

CONCEPT AND COMPONENTS OF A MARKET SURVEILLANCE SYSTEM

MARKET SURVEILLANCE - GENERALLY

Important in the modern marketplace characterized by computers, automation and transparency of market information is a system, utilizing those characteristics, designed for the surveillance of the market itself looking for abnormalities in such things as prices and volume. Requirements include in addition to a computer system, information, implementing procedures and trained staff to implement the procedures. Data, detection, analysis, investigation and prosecution are the necessary steps for such a system to be effective. A market surveillance system properly designed and operating efficiently necessarily adds to the credibility of a market and the perception in the minds of investors that it is fair. Illegal or improper trading has the opposite result.

Effective market surveillance does not exist in India today. Evidence of this is that successful prosecutions for insider trading or manipulation are rare to non-existent. Discussions with members of the industry indicate that such abuses are not only common but are considered by some to be rampant. The National Stock Exchange (NSE) appears dedicated to the task of attacking these insidious practices but, without an effective prosecution process, success is uncertain. That process does not appear to exist today either at the NSE or the government level. Nevertheless, efforts should not be diminished to achieve a successful market surveillance program. In addition to other things, this effort should involve an aggressive program to pressure the government to develop effective administrative and criminal prosecution capabilities and a resolve on the part of NSE that it will take action internally when such is possible.

THE CONCEPT OF MARKET SURVEILLANCE

The purpose of a market surveillance system is the detection of illegal activity such as insider trading, market manipulation, "front running", and "marking the close", among other improper conduct. It can also be used for other market-watching activities which may be specific to a particular stock exchange.

The term Market Surveillance System means a system designed for surveillance of market activity by utilization of a computer or computers programmed to (a) identify aberrational

movements in prices or volume based upon historical data, (b) investigate such identified aberrations by specially trained analysts and investigators and (c) where warranted prosecute or take disciplinary action. The data components of a market surveillance system are such that a complete audit trail of activity of all securities in the system is provided to better enable successful prosecution.

A well developed system of this type would have an automated on-line and off-line stock alert process employing statistical models that take into consideration security specific parameters, market behavior and the occurrence of news. It would also be capable of storing news stories by stock symbol and providing a complete audit trail of quotations and transactions. Other systems storing related information would complement such a system which would be designed with the peculiarities of the particular market in mind.

Nevertheless, it should be noted that a properly programmed market surveillance system is not a be all and end all to market surveillance. All a system does is raise red flags as to the possibility of improper activity and this is the case irrespective of the sophistication of the system. There is always the necessity to develop additional data to support subsequent prosecutions. This can be obtained only by follow-up and, in most cases, by field investigation after the red flag has been raised. This need exists whether the system is highly sophisticated or one that is operated manually. Thus, irrespective of the system utilized it is essential to have an adequate complement of competent, well trained professionals.

Normally a self-regulatory organization (SRO), rather than the government securities regulatory agency, will operate the market surveillance system. The ~~government~~ agency will exercise an oversight function. This is obviously the most economical approach since all of the information is in the exchange's system. In some countries, the government regulatory agency receives data from that system to assist it in performing its oversight function. There must be government involvement in an effective market surveillance program because many situations arise where the self-regulatory organization does not have jurisdiction over some of the ~~perpetrators~~ of the wrongdoing, for instance, members of the public. In almost all insider trading cases involve people over whom the self-regulatory organization does not have jurisdiction. After the suspicious activity is flagged and the SRO has investigated to the limits of its jurisdiction, it hands the case over to the government regulator which has subpoena authority and jurisdiction over all citizens. This may also happen in manipulation and other complex cases. In some countries, it is not unusual that the SRO's investigators remain in the case to help the securities commission in its continuing investigation and ultimate prosecution.

Notwithstanding the transfer of certain enforcement matters to the government regulator, the primary regulatory function is centered at the self-regulatory organization level. Most other types disciplinary cases prosecuted by a self-regulatory organization are not handed off to the

government because the cases are against members of the SRO and it therefore has jurisdiction. The principle of self-regulation is that to the extent possible the self-regulatory organization disciplines its members for their transgressions.

RECOMMENDATION AS TO MARKET SURVEILLANCE

If a market surveillance system is to have any meaning, it is important that capable staff in adequate numbers be retained and that they be well trained in the theory, operation and implementation of a market surveillance function as well as investigative techniques that are pursued when a red flag on certain activity is raised.

Automation does not eliminate the necessity for well-trained personnel to implement the system. In fact, it accentuates the need. Automation merely makes the surveillance effort more efficient and effective. It is essential in an active market.

Components of a Properly Designed Market Surveillance System

In order to develop an effective automated market surveillance function, the following requirements should be specified:

1. a practical way to narrow the focus of examination. Statistically valid procedures and techniques should be used to identify aberrational market behavior.
2. a methodology triggering intra day alerts for unusual price or volume activity
3. a complete transaction audit trail from customer order to trade settlement and easy access to such historical data for surveillance analysis.
4. a methodology for acquiring and integrating outside information concerning people and relationships to trace leakage of inside information and illegal trading.
5. a methodology to collect and integrate listed company and member firm submissions, press releases and depositions regarding key corporate events, participants, discussion topics and dates.
6. a coherent and rigorous analytic framework to use this information and support different analytic styles in surveillance analysis and investigations.

Necessary Steps

In order to meet these requirements, the following steps must be taken:

1. enable data from the trading system and the clearing system to be utilized by the surveillance system.
2. develop statistically valid alert measures for unusual price and volume, unusual broker concentration, and unusual broker or customer participation to manipulate closing prices.
3. collect and maintain listed company, broker and customer data in electronic databases. These should include:
 - listed company data on dividends, reorganizations as soon as they are announced.
 - broker and salesman registration and violations history. An electronic linkage could be developed between SEBI (which maintains registration files) and the National Stock Exchange for this registry.
 - listed company and member firm directors, officers and organization charts. This information should be required to be kept current.
 - a watch list of suspicious traders and brokers. SEBI and NSE should coordinate this information.
 - listed company and member firm ownership and relationships. This information should be required to be kept current.
 - a private database of relationships, rumors, tips, etc.
4. require listed companies and member firms to provide the NSE with chronologies of key corporate events, participants, dates, and discussion topics to assist in insider trading and market manipulation investigations. The market surveillance system should provide:
 - an easy way to enter the chronology dates, events and participants into the system
 - a facility to match trading records with chronology participants, their associates and event dates
5. develop market surveillance analysis and investigation procedures to:

- associate and combine all trading done for a single entity through several brokers
 - associate traders to all names found in the trading and customer name and address records
 - associate traders with insiders identified in the chronology by various criteria selected by the analyst:
 - similar name
 - similar address or proximity
 - common memberships in clubs, fraternities and other organizations
 - analyst hypothesis
6. produce trading reports to identify trading rule violations when such trades cannot be prevented in the trading system:
- proprietary trading ahead of customer orders
 - counter trades between brokers
 - brokers dealing in listed companies where a dealer, director or employee is also a director or officer
 - brokers dealing in listed companies where a broker director or employee is also a director or officer
7. develop exception reports to identify:
- discrepancies in trading and settlement volumes between trading and clearing systems
 - brokers with persistent order corrections and cancellations
 - brokers and stocks that consistently require exchange approval to complete the trade
 - brokers with excessive fails
8. develop a management information system that combines all information, for example:
- top gainers and losers with market share

- volume leaders compared to average daily volume
- summary up/down volume and gainers/losers
- graphical displays
 - NSE index real time
 - NSE volume intra day and historically
 - industry volume intra day and historically
 - order depth within 5% of quote by stock and industry

An ancillary benefit of a properly designed system, is that it has the ability to assist management in evaluating analyst performance and the effectiveness of the market surveillance function. Thus, the system should maintain:

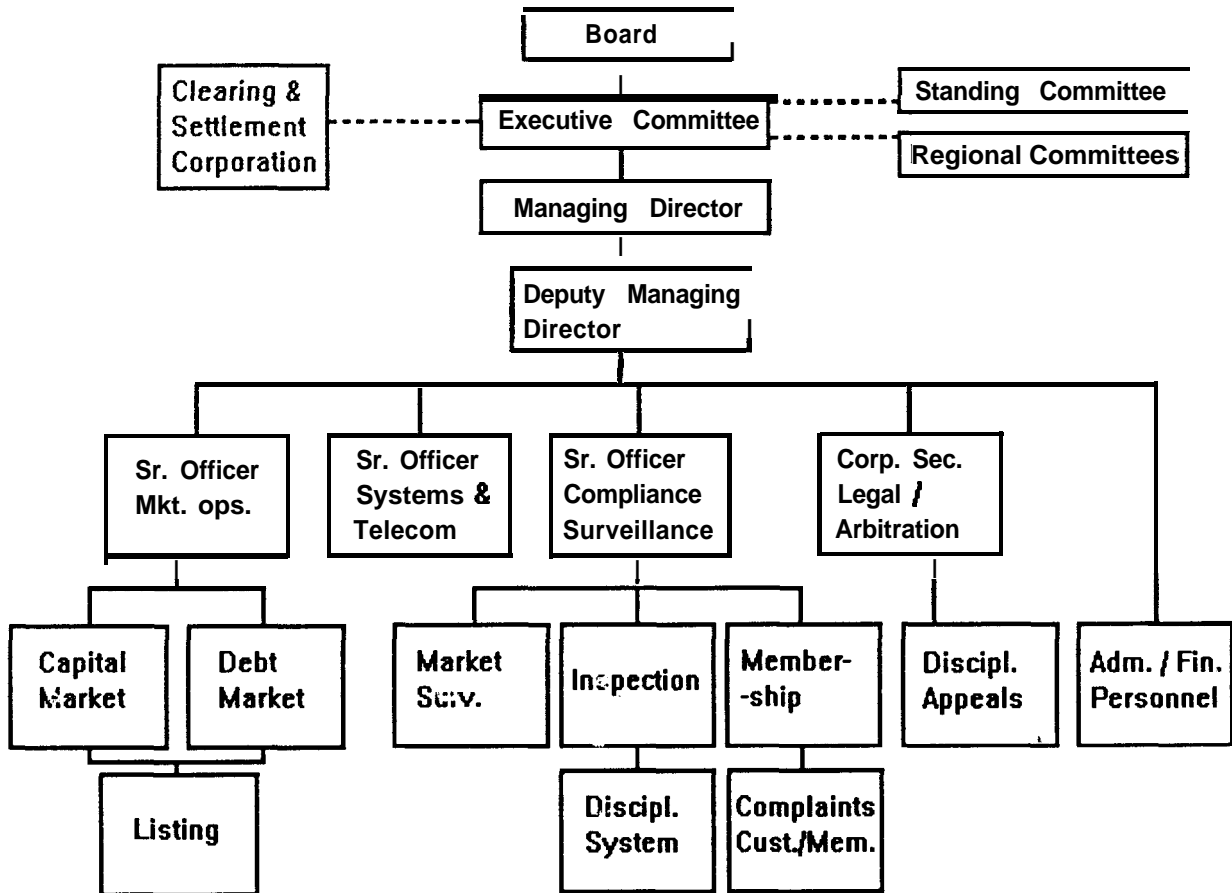
- all alerts generated and related analysis and investigation results
- dates of major steps in analysis and investigation
- interview findings
- tips, complaints and their resolution.

TRAINING

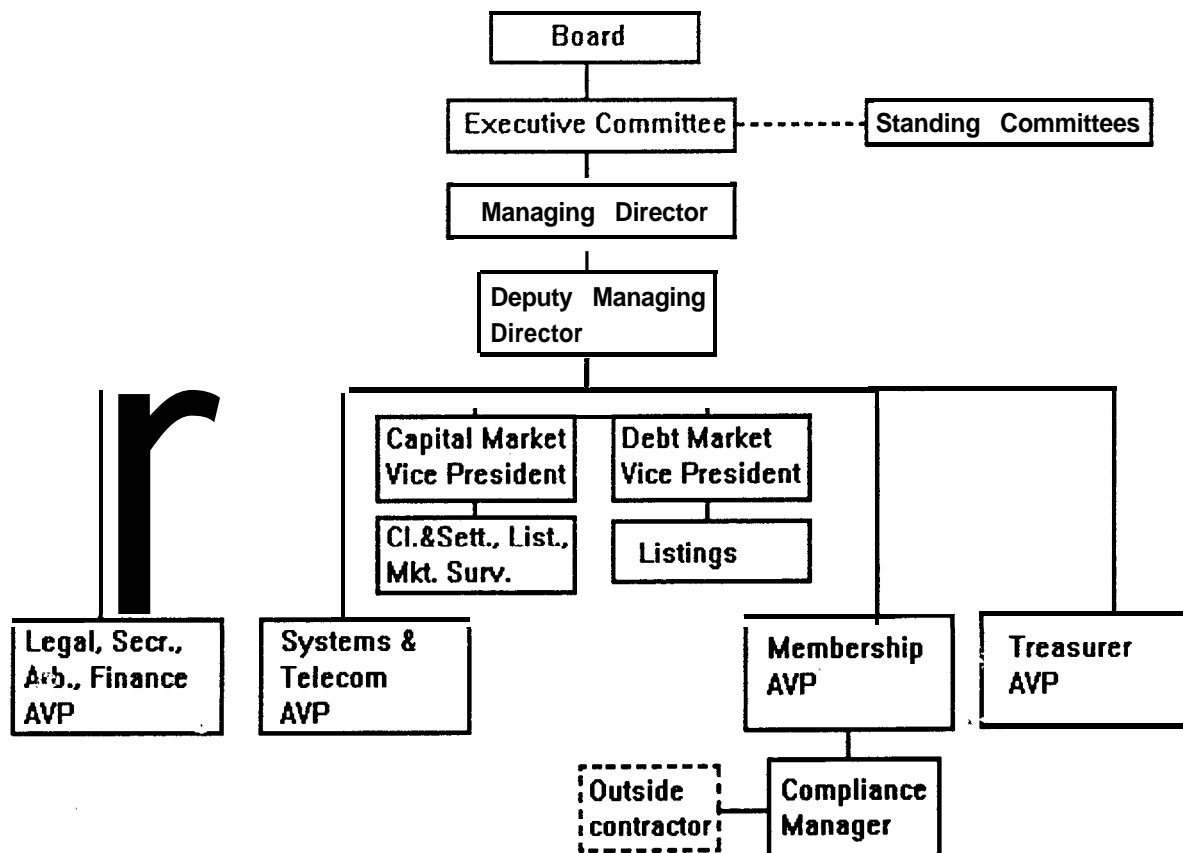
Training of personnel involved in all aspects of the market surveillance process **cannot** be overemphasized. Thus, training of the analytical, investigative and **disciplinary/prosecutory** personnel must be thorough and complete. This training should be by instruction **from** persons who are experienced in the operation of market surveillance systems and the investigation and prosecution of cases which result therefrom. This training can probably **only** be obtained abroad and probably only in the United States. The two leading and most sophisticated market surveillance systems in the world are those operated by The NASDAQ Stock Market and the New York Stock Exchange. Direct training from one or both of these agencies should be obtained for market surveillance analysts and investigators. Investigators should also receive training directly from persons who have successfully investigated and prosecuted manipulation and insider trading cases. Those involved in the disciplinary or **prosecutory** functions should receive training from **prosecutors** who have successfully prosecuted such cases. Insider trading and securities manipulation cases are **difficult** to prove and are time consuming in the development of proof, hence, expert training from persons who have done it is imperative. Training in these areas can probably be obtained best from the United States Securities and

Exchange Commission. Also, the National Association of Securities Dealers has for many years had an Anti-fraud Department with a complement of highly trained investigators which has much experience in pursuing manipulation cases. An effort should also be made to obtain training from prosecutors in the United States Justice Department who have prosecuted insider trading and manipulation cases.

ATTACHMENT 6 - Proposed Organizational Chart



ATTACHMENT 7 - Present Organizational Chart



ATTACHMENT 8A

**DELEGATION OF POWERS TO THE MANAGING DIRECTOR
CAPITAL MARKET SEGMENT REGULATIONS
relating to trading operations (Regulations - Part A)**

Reg. No.	Item	Recommendation
1.3.1	To approve an office or premises of a trading member for trading on the NEAT system and carrying out back office work.	
1.3.5	To notify any other place as Branch office in relation to trading member.	
2.1.2	To allow trading only through approved workstation(s) located at approved locations.	
2.1.3	Assignment of codes to trading members' users.	
2.1.7	To specify purposes for which trading software can be used; the equipment on which the software can be used.	
2.1.8	Permission to trading member / participant whether on their own or through any other person on their behalf, to publish, supply, show <i>or</i> make available, or reprocess, retransmit, store or use, facilities of the trading system or information provided by the trading system.	
2.2.2	Number of users permitted per trading member.	
2.2.3	Terms and conditions for appointment of users.	

Reg. No.	Item	Recommendation
2.2.7	Password expiry period.	
2.2.8 a)	Approval of authorized person as user.	
2.2.8 d)	Permission to trading member / participant to appoint users who were earlier trading member or in employment of another trading member against whom disciplinary action was initiated by NSE or any other stock exchange.	
2.2.9	Powers to reject applications made under 2.2.8 a) or at any such time withdraw any such approval granted before.	
2.2.10	To prescribe the manner and the format in which the trading member / participant can request for change in User ID number or cancel the authority given to its user.	
2.2.13	Level of access of users of trading members.	
2.2.14	Change of access of user.	
2.3.1	Declaration of holidays.	
2.3.2	To decide unscheduled opening and closing of the markets or segments for trading.	
2.4.1	Declaration of trading hours.	
2.5.1	Determination of minimum disclosed quantity.	
2.5.2	Determination of GTC expiry period.	
2.5.5	Determination of lot size.	

Reg. No.	Item	Recommendation
2.5.6	Determination of price steps.	
2.6.1	Determination of trade types.	
2.6.2	Determination of market types.	
2.6.4	Determination of transaction types.	To be ratified by the Executive Committee in the next meeting.
3.1.2	Suspension and de-suspension of securities.	To be ratified by the Executive Committee in the next meeting.
3.1.3	Suspension and de-suspension of trading member / participant.	
3.2.4	Procedure and conditions for amendment / cancellation of orders.	
3.4.1	Availability of order attributes.	
3.4.5	Order books.	To be ratified by the Executive Committee in the next meeting.
3.5	Contract note details.	
4.1.5	Seeking explanation from trading members regarding professional conduct, level of service	
4.2.1 d)	Authority of inspection	
4.5.2	Adherence to trading practices in code of conduct for trading members.	To be ratified by the Executive Committee.
5.2 (c)	Selection of common arbitrators from the lists submitted by the parties.	
5.4.1 (a&d)	Forwarding of documents to the respective arbitrating parties.	
5.4.1 (h)	Fixing of date, time and place of arbitration.	

Reg. No.	Item	Recommendation
5.5.3	Collection of fees and charges from the parties and payment to arbitrators and meeting other costs.	
5.7	Intimation of appeal to the parties and forwarding of relevant documents.	
5.10	Determination of time, date and place of hearing.	
6.1.2	To prescribe requirement in terms of books of accounts, records and documents to be maintained by the trading members.	
7.1.1 (a&b)	Appointment of inspection authority.	
7.2.1	To give reasonable notice to trading members before inspection.	
7.2.2	To direct in writing for taking up inspection without notice.	
7.4.2	To approve disclosure of any information acquired during the process of inspection to any other person, firm, company or authority as required by the law.	
7.4.3 (a&b)	To communicate findings of the inspection to the trading members.	

ATTACHEMENT 8B

DELEGATION OF POWERS TO THE MANAGING DIRECTOR
CAPITAL MARKET SEGMENT REGULATIONS
relating to trading operations (Regulations - Part B)

Reg. No.	Item	Recommendation
2.2	Cleared and Non-cleared Securities	Securities already admitted to Capital Market segment are required to be placed on the Cleared Securities list. This may be delegated to the Managing Director.
2.3	Addition or Suspension or Removal from Cleared Securities list	This may be delegated to the Managing Director.
2.7	Deals in Cleared Securities deemed to be for current clearing	Special stipulations, for example, to allow inter-custodian settlement in securities by hand-delivery or declaring no-delivery period during corporate action etc., are required to be permitted. This may be delegated to the Managing Director.
2.9	Deals in Non-Geared Securities for hand delivery	There are operational requirements for declaring securities in no-delivery etc. This may be delegated to the Managing Director.
2.10	Deals in Provisional Documents / Securities	There are operational requirements for declaring securities in no-delivery etc. This may be delegated to the Managing Director.
2.11	Deals in Non-cleared securities other than the above	There are operational requirements for declaring securities in no-delivery etc. This may be delegated to the Managing Director.

Reg. No.	Item	Recommendation
2.12	Deals for Special Delivery	Permission to enter into special delivery (typically no delivery period due to corporate action) may be delegated to the Managing Director.
3.1	Measures to meet emergencies	This may be delegated to the Managing Director. Under Rules of the Exchange, measures to meet emergencies are required to be ratified by the EC within 24 hours.
4.1	Settlement by Hand Delivery	Provisions for settlement by hand delivery will require to be specified from time to time. This may be delegated to the Managing Director.
4.2	Settlement through Clearing House	Provisions for settlement through Clearing House will require to be specified from time to time. This may be delegated to Managing Director.
4.3.1	Delivery through Clearing House	Conditions for offsetting transactions i.e. netting, which will determine the allocation method used to calculate obligations, will require to be specified, if any. This may be delegated to the Managing Director.
4.3.2	Payment through Clearing Bank	Conditions for offsetting transactions i.e. netting, which will determine the allocation method used to calculate obligations, will require to be specified, if any. This may be delegated to the Managing Director.
4.4	Delivery in Cleared Securities when outside Clearing House	Deals may be required to be settled outside Clearing House (e.g., for institutional market sub-segment etc.). This may be delegated to Managing Director.

Reg. No.	Item	Recommendation
4.5	Change in Settlement Procedures	Operational changes may require to be made from time to time to allow deals to be settled through clearing or by hand delivery. This may be delegated to the Managing Director.
4.8	Contracts subject to change in Settlement Procedure	Notice has to be given for changes, if any as above. This may be delegated to the Managing Director.
5.1	Scheduled date and time for settlement on non-cleared securities	Dates and times are required to be prescribed for each settlement. This may be delegated to the Managing Director. Any changes from normal schedules may be ratified at the next EC meeting.
5.2	Delivery for non-cleared securities	Manner and delivery units are required to be specified from time to time. This may be delegated to the Managing Director. Any changes from normal schedules may be ratified at the next EC meeting.
5.5	Payment for non-cleared securities	Manner and mode of payments are required to be specified from time to time. This may be delegated to the Managing Director.
5.1	Scheduled date and time for settlement on cleared securities	Dates and time are required to be prescribed for each settlement. This may be delegated to the Managing Director. Any changes from normal schedules may be ratified at the next EC meeting.
5.2	Alteration of schedules	It may be required to alter schedules especially in the event of unscheduled holidays etc. This may be delegated to the Managing Director.

Reg. No.	Item	Recommendation
6.3	Clearing and Settlement Process	Manner and process for functioning of Clearing House and Clearing Members are required to be specified from time to time. This may be delegated to the Managing Director. Any changes in the manner of settlement may be ratified at the next EC meeting.
6.4	Clearing Forms	Clearing Forms are required to be specified from time to time. This may be delegated to the Managing Director.
6.9	Mode of payment	Mode of funds payment for clearing members may require to be specified from time to time. This may be delegated to the Managing Director.
6.10	Receipt of securities	It may be required on occasion to hold back delivery of securities to receiving members on account of defaults etc., which will require to be determined from time to time. This may be delegated to the Managing Director.
5.11	Receipt of Funds	It may be required on occasion to hold back payment of funds to receiving members on account of defaults etc., which will require to be determined from time to time. This may be delegated to the Managing Director.
7.1	Which documents good delivery	Besides the general guidelines issued by MoF , there may be requirements to specify what constitutes good delivery in specific instances. This may be delegated to the Managing Director.

Reg. No.	Item	Recommendation
7.3.3	When allotment letter ceases to be good delivery	There may be requirements to declare allotment letters as good delivery in specific instances. This may be delegated to the Managing Director.
7.4	Split and Transfer Receipts when good delivery	There may be requirements to declare split and transfer receipts as good delivery in specific instances. This may be delegated to the Managing Director.
7.6.1	Prescribed delivery units	It will be required to specify delivery units which constitute good delivery. This may be delegated to the Managing Director.
7.11	Disputes relating to good / bad delivery	There may be requirements to determine from time to time the day / period required to report bad delivery other than already specified. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
7.12	Replacement of bad delivery	There may be requirements to determine from time to time the day / period required to replace bad delivery other than already specified. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
8.3	Failure to deliver	On failure to deliver the delivering member will be debited to the extent of securities short valued at specified valuation which will be announced every trading period. This may be delegated to the Managing Director.

Reg. No.	Item	Recommendation
8.6	Disabling a trading member	Upon failure to deliver or pay a trading member will be disabled from trading till remedial action is taken. This may be delegated to the Managing Director.
9.3.2	Closing-out without notice	The Exchange may require to close-out contracts in exceptional circumstances without notice. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
9.6	Compliance before closing-out	The Exchange may allow a member to effect compliance before closing-out is effected. This may be delegated to the Managing Director.
9.7	Bids and Offers	The Exchange may allow members against whom closing-out is to be effected to make a bid or offer. This may be delegated to the Managing Director.
9.8	Closing-out how effected	The method and means of closing-out are required to be determined on a case to case basis. This may be delegated to the Managing Director.
3.10	Securities when not bought-in	It will be required to determine on a case to case basis when a security cannot be bought-in. This may be delegated to the Managing Director.
9.11	Postponement of closing-out	It may be required to postpone closing out in a particular case due to various reasons such as market conditions. This may be delegated to the Managing Director and may be ratified at the next EC meeting.

Reg. No.	Item	Recommendation
9.12	Suspension or postponement of closing-out	It may be required to suspend or postpone closing out in a security or securities due to various reasons such as market conditions. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
10.2	When cum and ex-benefits	It will be required to declare the dates from which securities are traded ex- benefits. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
10.3.4	Deduction of dividend / cash bonus from purchase price	When dividend or cash bonus is not known, it may be required for the Exchange to make provisional adjustments. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
10.4.2	Payment of deposits	Amount retained as a deposit by Clearing Bank will have to be returned to the seller at such time as the Exchange may determine . This may be delegated to the Managing Director.
10.5	Letters of Renunciation	Period from when letters of renunciation tendered are acceptable will require to be determined from time to time. This may be delegated to the Managing Director.
10.7.1	Application for Rights	The Exchange will be required to determine conditions when a buyer can claim rights entitlement. This may be delegated to the Managing Director.

Reg. No.	Item	Recommendation
11.7.1	Period for Rectification or Replacement	Period to replace defective documents may require to be increased under several circumstances. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
11.7.2	Refund of moneys	The Exchange may be required to determine, from time to time, the price at which defective securities not replaced will require to be valued. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
11.7.4	Rectification after refund	The period provided for rectification after refund as above may be required to be changed from time to time. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
12.1	Functions of Clearing Bank	It will be required to specify and direct the various functions of the Clearing Bank from time to time. This may be delegated to the Managing Director.
12.2	Members account with Clearing Bank	It will be required to specify and direct the various purposes for which member accounts with Clearing Bank maybe used for. This may be delegated to the Managing Director.
13.1.1	Exchange to maintain Clearing House	It will be required to specify and direct the various functions of the Clearing House from time to time. This may be delegated to the Managing Director.

Reg. No.	Item	Recommendation
13.3	Authority to Pledge	It may be required by the Exchange to pledge securities due to members. This may be delegated to the Managing Director.
13.6	Clearing Assistants for Clearing House	Forms will require to be specified for this purpose. This may be delegated to the Managing Director.
14.2	Delivery and Payment through Custodians and Clearing Member Banks / Institutions	Custodians and Clearing Member Banks / Institutions have to be approved from time to time for inclusion in the list. This may be delegated to the Managing Director and may be ratified at the next EC meeting.
14.5	Inclusion in or Removal from Approved List.	This may be delegated to the Managing Director and may be ratified at the next EC meeting.
15.2	Clearing House Split Receipts	Forms will require to be specified for this purpose. This may be delegated to the Managing Director.

ATTACHMENT 8C

DELEGATION OF POWERS TO THE MANAGING DIRECTOR
WHOLESALE DEBT MARKET REGULATIONS

relating to trading operations

Sr. No.	Reference of trading regulations	Powers delegated to the Managing Director	Remarks
Chapter 1 - Definitions			
1.	Regulation 1.3.1	To approve an office or premises of a Trading Member for trading on the system and carry out back office works.	
2.	Regulation 1.3.6	To notify any place as a Branch Office in relation to a Trading Member.	
Chapter 2 - Trading System			
3.	Regulation 2.1.3	To give a unique identification to a Trading Member / Participant	
4.	Regulation 2.1.7	To specify purposes for which the trading software can be used; the equipments on which the software can be used; permission to trading members to copy, alter, modify or make available to any other person the trading software.	

Sr. No.	Reference of trading regulations	Powers delegated to the Managing Director	Remarks
5.	Regulation 2.1.8	Approval to Trading Member / Participant whether on their own or through any other person on their behalf to publish, supply, show or make available or reprocess, retransmit, store, manipulate or use the facilities of the NEAT system or the information provided by the NEAT system.	
6.	Regulation 2.2.1	Appointment of Users by Trading members and participants.	
7.	Regulation 2.2.2	Decision on number of users per trading member / participant.	
8.	Regulation 2.2.3	To prescribe terms and conditions for appointment of users of trading members / participants.	
9.	Regulation 2.2.4	To allot unique identification number to users.	
10.	Regulation 2.2.7	To set password expiry period.	
11.	Regulation 2.2.8	Permission to trading member / participant to appoint users who were earlier trading member or in the employment of another trading member against whom disciplinary action was taken by NSE or any other exchange.	

Sr. No.	Reference of trading regulations	Powers delegated to the Managing Director	Remarks
12.	Regulation 2.2.9	Powers to reject application made for users or withdraw approval granted previously or suspend a user temporarily from access to the system and prescribe conditions for revocation of such suspension.	
13.	Regulation 2.2.10	Prescribe the manner and format in which the trading member! participant can request for change in User Identification Number or cancel the authority given to its User.	
14.	Regulation 2.2.13	Authority to notify different levels of users for trading members / participants.	
15.	Regulation 2.3.1	To determine and notify holidays.	
16.	Regulation 2.3.2	To decide unscheduled closing and opening of segments or markets.	
17.	Regulation 2.4.1	To decide and announce the normal trading hours for every calendar year in advance segment-wise / settlement period wise.	
18.	Regulation 2.4.2	Authority to extend or reduce trading hours.	

Sr. No.	Reference of trading regulations	Powers delegated to the Managing Director	Remarks
19.	Regulation 2.5	To prescribe trading parameters relating to NEAT system such as types of order books, availability of order books, minimum disclosed value, number of days for GTC orders, minimum order size and increments, steps in which prices can be entered, maximum and minimum repo days.	
20.	Regulation 2.5.5	Authority to change status of a user.	
21.	Regulations 2.6.2 & 3.1.1	To define the level of access that shall be available to trading members / participants for different trade types, market types and nature of dealings in call segment and for different settlement period and trading hours.	EC or any committee set up for the purpose but in exceptional circumstances the M.D. should be authorized to make changes in these levels of access for reasons to be recorded in writing and to be ratified by the EC or any committee thereafter.
22.	Regulation 2.7	Authority to carry out certain functions on behalf of trading member / participant in the event of failure of the trading member / participant workstation and to prescribe terms and conditions for the same.	

Sr. No.	Reference of trading regulations	Powers delegated to the Managing Director	Remarks
Chapter 3 - Dealings in Securities			
23.	Regulation 3.1.1	To permit dealing in securities on the different segments, market types, trade types and for different settlement period, trading hours.	
24.	Regulations 3.1.2 & 3.1.3	To suspend / revoke trading in particular securities and prescribe conditions for the same except for suspension / revocation during / after shutdown period.	EC and for suspensions / revocation during shutdown period the M.D.
25.	Regulation 3.1.4	To prescribe terms and conditions for trading members to trade on their own or on behalf of constituents and also the power to prohibit the same.	
26.	Regulation 3.1.5	Authority to restrict conditionally or unconditionally a trading member / participant in dealing in specified securities.	EC but in exceptional cases the M.D. can take decisions and they can be subsequently ratified by the EC.
27.	Regulation 3.2.4	To prescribe conditions for amendment and cancellation of orders.	
28.	Regulation 3.2.7	To prescribe the modalities for turnover limit validation and also the manner in which all regulations relating to turnover limit will apply.	
29.	Regulation 3.2.8	To specify the markets in which trade cancellations can be effected.	

Sr. No.	Reference of trading regulations	Powers delegated to the Managing Director	Remarks
30.	Regulation 3.2.9	Authority to approve or reject trade cancellation requests and also to undertake suo-moto cancellation of trades.	
31.	Regulation 3.4	To prescribe the type of orders and order attributes that can be placed on the system.	
32.	Regulation 3.4.4	To prescribe various validation requirements for orders entered into the system by trading members.	
33.	Regulation 3.4.5 (a)	To prescribe the order books that will be maintained by the trading system and the matching rules.	
34.	Regulation 3.4.5 (b)	Authority to modify or change the matching algorithm relevant to any market or order book.	To be ratified by the EC subsequently.
35.	Regulation 3.4.5 (f)	To provide for manual matching facility for specific categories of order books and prescribe the terms and conditions for Exchange approval.	
36.	Regulation 3.5.1	To prescribe the format of contract notes to be issued by trading members and the procedure for the same.	

Sr. No.	Reference of trading regulations	Powers delegated to the Managing Director	Remarks
Chapter 4 - Conduct of Business by Trading Members			
37.	Regulation 4.1.5	Powers to seek explanation from trading members regarding their service or professional conduct or conduct of any of its staff suo moto or on complaint from another trading member or constituent.	
Chapter 7 - Arbitration			
38.	Regulation 7.4	To forward various documents and papers to the applicant and the respondent during the arbitration process.	
39.	Regulation 7.5.3	To collect fees and charges for the arbitration process and pay fees to the arbitrators and make other disbursements in the connection with the other costs and expenses of the reference.	
40.	Regulation 7.7	Intimation of appeal to the parties of reference.	
II.	Regulation 7.11	To fix the time and place of the initial hearing by the arbitrator or appellate authority.	
Chapter 9 - Inspection			
12.	Regulation 9.1.1	To appoint own officials or outside professionals as inspecting authority to undertake inspection of books of accounts and other records of trading members.	

Sr. No.	Reference of trading regulations	Powers delegated to the Managing Director	Remarks
43.	Regulation 9.1.1 (b)	To notify trading members regarding appointment of outside professionals as inspecting authority.	
44.	Regulation 9.2.1	To give reasonable notice to trading members before inspection.	
45.	Regulation 9.2.2	To direct in writing for taking up inspection without prior notice to trading members.	
46.	Regulation 9.4.2	To approve disclosure of any information acquired during the process of inspection to any person, firm , company or authority as required under any law.	
47.	Regulation 9.4.3 (a)	To communicate findings of the inspection.	
48.	Regulation 9.4.3 (b)	To take suitable measures other than disciplinary action on the basis of inspection report as is necessary in the public interest.	

ATTACHMENT 8D

DELEGATION OF POWERS TO THE MANAGING DIRECTOR UNDER LISTING REGULATIONS

All the powers exercisable by the Executive Committee under these regulations except the following :

Regulation no. Chapter IV (1)

To decide the suspension in trading of a particular security for a specified period of time or delisting of a security admitted to trading on the Exchange when

- (i) the issuer contravenes or fails to comply with laws relating to securities dealings and NSE byelaws, rules, regulations, notifications or provisions of listing agreement executed with the NSE, including any circulars prescribed by the NSE.
- (ii) the issuer makes misrepresentations in its application, financial statements or reports filed with the NSE or disclosed to the general public which may seriously and adversely affect the rights and benefits or decision making of investors or cause a change in the price of securities.
- (iii) the issue fails to disclose material information or makes an error in disclosing material information which may seriously and adversely affect the rights and benefits or decision making of investors or cause a change in the price of securities.
- (iv) any other reason to be recorded in writing.

Chapter IV (6)

To readmit to dealings the securities of an issuer whose admission to dealings has been previously withdrawn.

Chapter IV (7)

To grant approval to the issuer seeking delisting of securities.

Regulation no. Chapter II (1)

To decide the securities to be admitted to listing -

- (i) for existing securities listed on other Exchanges where market capitalization is equal to or greater than Rs. 50 crores.
- (ii) for new issues where the issued and subscribed equity capital is equal to or greater than Rs. 10 crores.

Listing Agreement Clause 38

To determine the initial and annual listing fees to be paid by the issuer.